



April 2014

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## Recommended Citation

Michelle M. Arnopol, *Why Have Chapter 11 Bankruptcies Failed So Miserably: A Reappraisal of Congressional Attempts to Protect a Corporation's Net Operating Losses after Bankruptcy*, 68 Notre Dame L. Rev. 133 (1992).

Available at: <http://scholarship.law.nd.edu/ndlr/vol68/iss1/6>

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# Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts to Protect a Corporation's Net Operating Losses After Bankruptcy

Michelle M. Arnopol \*

## I. INTRODUCTION

Over the past two years, banner headlines have regaled readers with the Chapter 11 bankruptcy filings of such major corporations as Macy's, TWA, and Federated Department Stores.<sup>1</sup> These bankruptcies represent only a smattering of the myriad large and small businesses that have sought protection under Chapter 11 of the Bankruptcy Code in increasing numbers each year since the Code's inception in 1978.<sup>2</sup> Both the magnitude and sheer number of these Chapter 11 cases compels an examination of whether Chapter 11 is satisfying its intended purposes. Is Chapter 11 bankruptcy merely a stalling mechanism by which these businesses can temporarily fend off an inevitable liquidation, or does it instead provide an avenue for these businesses to reorganize successfully?

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1 R.H. Macy & Company filed for Chapter 11 bankruptcy protection on January 27, 1992. Carla Lazzareschi, *R.H. Macy Files For Bankruptcy*, L.A. TIMES, Jan. 28, 1992, at A1. Federated Department Stores, which operates 140 department stores, including Bloomingdale's and Burdines, filed for Chapter 11 relief in January 1990. Carla Lazzareschi, *Macy's Seeks Bankruptcy Protection; Q & A*, L.A. TIMES, Jan. 28, 1992, at D1. TWA filed for Chapter 11 bankruptcy protection on January 31, 1992. Christopher Corey, *TWA Plan May Hit Turbulence*, ST. LOUIS POST DISPATCH, Feb. 2, 1992, at 1E.

2 The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990)). For a discussion of the statistics illustrating the escalating numbers of Chapter 11 filings, see *infra* notes 16-17 and accompanying text.

When Congress enacted the Bankruptcy Reform Act of 1978<sup>3</sup> and created the Chapter 11 bankruptcy provisions, it envisioned that troubled businesses could use Chapter 11 as a tool to restructure and continue as viable concerns.<sup>4</sup> The House committee report emphasized that "the purpose of a business reorganization case, unlike a liquidation, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."<sup>5</sup>

Unfortunately, the goals of the Chapter 11 bankruptcy provisions have not materialized in practice. Empirical studies estimate that only between ten and twenty-seven percent of all businesses that file for Chapter 11 bankruptcy relief successfully reorganize.<sup>6</sup> Thus, the vast majority of businesses seeking Chapter 11 protection ultimately fail in their reorganization efforts. The failure of these businesses has a devastating impact on the national economy.<sup>7</sup> For example, on January 27, 1992, R.H. Macy & Company ("Macy's") filed for Chapter 11 bankruptcy. Macy's operates 251 department stores throughout the nation with annual sales of over

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3 92 Stat. at 2549.

4 H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

5 *Id.*

6 See Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code*, 57 AM. BANKR. L.J. 99, 107 (1983); Ed Flynn, Statistical Analysis of Chapter 11 (Oct., 1989) (unpublished manuscript, on file with the *Notre Dame Law Review*).

In 1989, Ed Flynn, Management Analyst for the Bankruptcy Division of the Statistical Analysis and Reports Division of the Administrative Office of the United States Courts, prepared a statistical analysis of Chapter 11 cases, using data prepared by an Ernst & Young, Inc. audit of confirmed Chapter 11 cases. Flynn, *supra*, at 13. The analysis was based upon the review of 2,400 confirmed Chapter 11 cases that have been filed since 1979. *Id.* The data showed that reorganization plans were confirmed in only 17% of Chapter 11 cases, and that over 25% of the confirmed plans were liquidating plans. *Id.* Thus, Mr. Flynn estimated that only between 10% and 12% of businesses seeking Chapter 11 bankruptcy protection culminated in a successful bankruptcy reorganization. *Id.* Of course, in rare circumstances Chapter 11 bankruptcy filings are dismissed when the debtor corporation is purchased prior to the confirmation of the reorganization plan. These cases may not be reflected in the foregoing statistics.

Professor Lynn M. LoPucki conducted an empirical study of Chapter 11 cases filed in the Bankruptcy Courts of the Western District of Missouri during 1979. LoPucki's data revealed that of the 41 businesses that had filed for Chapter 11 relief in 1979, only 11 of those businesses, or 27%, had successfully reorganized by 1983. LoPucki, *supra*, at 107. With the exception of these two studies, little data exists regarding the success of Chapter 11 bankruptcy filings.

7 The immediate economic impact can be seen through examples such as lost jobs and defaulted loans. The statement is not intended to address possible long-term economic benefits, such as allocative efficiency in the market.

seven billion dollars, employs over 69,000 people, and purchases goods from over 20,000 suppliers.<sup>8</sup> If Macy's is unsuccessful in its reorganization attempt, the assets of the corporation will have to be liquidated. As a result, it is likely that 69,000 people will lose their jobs, and 20,000 suppliers will lose a major, if not primary, purchaser of their goods. It is easy to envision the domino effect that just this one failed reorganization could have on the national economy if Macy's is unable to restructure successfully.

Similarly, unsuccessful Chapter 11 reorganizations of small businesses can also have a devastating impact on a local economy. For example, Grant Hardware ("Grant"), a national manufacturer of aluminum and steel drawer slides for office furniture and cabinets, relocated its operations to Harrisonville, Missouri.<sup>9</sup> Harrisonville is a small town of 8,000 located thirty miles south of Kansas City, Missouri.<sup>10</sup> To help attract the manufacturer to the area, the city procured \$1,700,000 in low interest bank loans,<sup>11</sup> \$395,000 in Community Development Block Grants, and \$360,000 in state loan guaranties for Grant.<sup>12</sup> In turn, the manufacturer brought 450 jobs to the area, becoming the city's largest employer.<sup>13</sup> In December of 1990, the corporation filed for Chapter 11 bankruptcy protection.<sup>14</sup> If Grant had been unable to reorganize successfully, a large portion of the city's work force would have been unemployed, local businesses would have suffered a loss of business due to the relocation of Grant's former employees, and local banks would have lost substantial sums due to the inability of both Grant and its unemployed work force to repay their loans. Fortunately, this scenario did not occur. While Grant was in bankruptcy, a German company purchased the corporation, retained 350 employees, repaid the secured debt in full, and repaid nearly twenty percent of Grant's unsecured debt.<sup>15</sup>

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8 See Lazzareschi, *R.H. Macy Files for Bankruptcy*, *supra* note 1, at A1.

9 Dan Margolies, *Germans to Buy Bankrupt Grant, Saving Jobs and Creditors' Money*, KAN. CITY BUS. J., Sept. 20, 1991, at 1.

10 Dan Margolies, *Grant's Rent Doubled by Parent Before Bankruptcy*, KAN. CITY BUS. J., Jan. 25, 1991, at 2.

11 *Id.* The bank loans were part of the MOBUCKS program under which state funds are deposited in banks throughout the state in return for their agreement to lend the money at low interest rates to local businesses.

12 *Id.*

13 *Id.*

14 *Id.*

15 Margolies, *supra* note 9, at 1.

The economic impact of unsuccessful Chapter 11 bankruptcies is even more troubling when one considers the escalating number of Chapter 11 petitions each year. As of September 30, 1991, Chapter 11 filings for the preceding twelve-month period totaled a staggering 20,394,<sup>16</sup> a figure which represents more than a fourteen percent increase over the 17,789 filings of the previous year.<sup>17</sup> Moreover, experts predict that this pattern will continue.<sup>18</sup>

No studies have been conducted which focus on the reasons why the Chapter 11 provisions have proven to be an ineffective mechanism for restructuring financially troubled corporations. One of the most likely factors accounting for the low success rate of Chapter 11 bankruptcies, however, appears to be the tax treatment afforded the net operating losses<sup>19</sup> of corporations seeking Chapter 11 relief.<sup>20</sup> A financially troubled corporation is far more likely to reorganize successfully if it can offset its income earned after bankruptcy with its net operating losses incurred prior to bankruptcy.<sup>21</sup> Although section 382 of the Internal Revenue Code

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16 ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLE F-2 (1991). This data is based only on Chapter 11 business filings.

17 ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLE F-2 (1990). This data is also based only on Chapter 11 business filings. Although some might argue that the dramatic increase in bankruptcy filings from 1990 to 1991 was caused by a downturn in the economy, statistics show that there has been an increase in Chapter 11 filings even in good economic times. For example, Chapter 11 bankruptcy filings increased dramatically from 20,023 in 1984 to 24,442 in 1986, a period during which general economic conditions were considered relatively good. See ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLE 10 (1989).

18 See, e.g., Alison L. Cowan, *Ringside Seat on Corporate Disasters*, N.Y. TIMES, Jan. 2, 1992, at D1.

19 Net operating losses ("NOLs") are defined *infra* notes 26-30 and accompanying text.

20 One commentator has suggested that a corporation's ability to undergo a successful reorganization is primarily dependent on its ability to protect its net operating losses in bankruptcy. See Robert A. Rizzi, *Corporate Organizations and Reorganizations*, 19 J. CORP. TAX'N 134, 134 (1992). Other commentators have observed that "[t]he reduced tax burden that results from preserving the NOL [in bankruptcy] may even provide the incremental cash flow that pushes the company over the fine line between a failed and a successful restructuring." Howard I. Sniderman et al., *A Tax Overview of Troubled Company Debt Restructuring*, 21 TAX ADVISER 199, 199 (1990). For a discussion of the tax treatment of net operating losses in bankruptcy, see *infra* notes 172-94 and accompanying text.

21 In the recent case of Official Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re Prudential Lines Inc.*), 928 F.2d 565 (2d Cir.), *cert. denied*, 112 S. Ct. 82 (1991), the Second Circuit held that a debtor corporation's net operating loss carryovers are a valuable asset and constitute "property of the estate" within the meaning of § 541 of the Bankruptcy Code. *Id.* at 569. Accordingly, the court barred the debtor corporation's par-

contains special provisions governing the preservation of net operating losses in Title 11 proceedings,<sup>22</sup> these provisions have proven wholly inadequate in practice. Accordingly, an amendment to the Internal Revenue Code is necessary if a corporation is to be allowed to utilize its net operating losses after bankruptcy and thereby preserve one of its most valuable assets.

This Article is premised upon two assumptions. First, it assumes that although the Chapter 11 provisions have not yet proven successful in practice, the goals underlying those provisions are laudable.<sup>23</sup> Accordingly, the Article asserts that Congress must act to remedy the ills of the Chapter 11 provisions in order to make them a more viable alternative to the Chapter 7 liquidation.<sup>24</sup>

Second, the Article assumes that a policy of tax neutrality underlies section 382 of the Internal Revenue Code. In other words, the purpose of the net operating loss provisions is to make tax law neutral so that transactions are entered into solely for business reasons and are not based on tax considerations, such as acquiring a troubled corporation's net operating losses to shelter otherwise taxable income.<sup>25</sup>

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ent from taking a worthless stock deduction with respect to the debtor's stock because such action would have destroyed the net operating losses and, therefore, violated the automatic stay authorized by § 362 of the Bankruptcy Code. *Id.* at 573-74.

22 I.R.C. § 382(d)(5)-(6) (1988 & West Supp. 1992). For a discussion of these special bankruptcy provisions, see *infra* notes 172-94 and accompanying text.

23 There are, however, those commentators who argue that Chapter 11 should be abolished in its entirety. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078 (1992). Others question whether the underlying premises of the Chapter 11 bankruptcy provisions have been justified. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW*, 209-24 (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986). A response to the arguments made by these commentators is beyond the scope of this Article.

24 11 U.S.C. §§ 701-766 (1988).

25 A number of commentators have written articles addressing the issue of whether tax neutrality is the true policy underlying § 382. See, e.g., Michael L. Schultz, *Section 382 and the Pursuit of Neutrality in the Treatment of Net Operating Loss Carryovers*, 39 KAN. L. REV. 59 (1990); Daniel L. Simmons, *Net Operating Losses and Section 382: Searching For a Limitation on Loss Carryovers*, 63 TUL. L. REV. 1045 (1989).

Similarly, several commentators have suggested alternatives to the treatment of net operating loss carryovers set forth in § 382. For example, some argue that corporations should be reimbursed for their losses on a yearly basis by the government. See George K. Yin, *Of Diamonds and Coal: A Retrospective Examination of the Loss Carryover Controversy*, 48 N.Y.U. INST. ON FED. TAX'N 41-1, 41-28 (Pt. 2 1990) and articles cited therein. Others argue that a corporation should only be entitled to losses to the extent of paid-in capital and past earnings, so that any loss based on creditors' investments would be disallowed. *Id.* at 41-39. Still others suggest that the free transferability of losses should be allowed. *Id.* at 41-24.

This Article will first outline the history of judicial and statutory limitations on the free transferability of net operating losses, highlighting congressional attempts to afford more favorable treatment to troubled corporations reorganizing in Title 11 proceedings. It will then examine the operation of section 382 of the 1986 Code, again focusing on those provisions designed to assist in the successful reorganization of these corporations, and will demonstrate the wholesale inability of these provisions to preserve the net operating losses of troubled corporations. Finally, the Article will propose an amendment to section 382 that would increase the likelihood that corporations will be allowed to retain their net operating losses following bankruptcy. This amendment would improve the success rate of Chapter 11 bankruptcies, effectuate the legislative policies underlying section 382, and reduce the devastating economic impact of corporate liquidations.

## II. HISTORICAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS

A corporation incurs a net operating loss when its allowable deductions for a taxable year exceed its gross income for that year.<sup>26</sup> As early as 1918, Congress recognized a need to allow a corporation to offset its losses from one taxable year against income earned in prior or subsequent taxable years<sup>27</sup> in order to prevent distortions created by the use of an arbitrary annual accounting system of taxation.<sup>28</sup> Under present law, a corporation

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26 I.R.C. § 172(c) (1988 & West Supp. 1992).

27 Revenue Act of 1918, ch. 18, § 204(b), 40 Stat. 1057, 1061 (1919). Under section 204(b) of the Act, a corporation was permitted to carry a net operating loss back one year or forward one year.

28 S. REP. NO. 617, 65th Cong., 3d Sess., pt. 1, at 7 (1919), *reprinted in* JACOB S. SEIDMAN, *LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1861-1939*, at 901 (1938). The report stated:

At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross income the excess (or in other words the net loss) can not [sic] be carried over into the next year . . . . The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, many often result in grave injustice.

*Id.* For example, without the net operating loss carryover provisions, a corporation that had a \$50,000 loss in Year One because of front-loaded expenses, and \$50,000 of income in Year Two would have to pay tax on the \$50,000 of income recognized in Year Two and would receive no benefit from Year One's loss. Conversely, an identical corporation whose expenses fortuitously fell within the same taxable year as its income would pay no tax. This result violates principles of horizontal equity—that similarly situated taxpayers be

can carry a net operating loss back three years<sup>29</sup> and forward fifteen years<sup>30</sup> to offset income that it earns during those years.

*A. Restrictions on Net Operating Loss Carryovers Before  
the 1954 Code: Initial Attempts by the Courts  
and Congress to Limit Free Transferability*

Net operating losses are a very valuable commodity because they can be used to offset otherwise taxable income. Soon after net operating loss carryovers became part of the Code in 1918, profitable taxpayers realized that if they could acquire a loss corporation and succeed to its net operating losses, they could use those net operating losses to reduce or completely eliminate the income tax on their profits. Even before the first objective standards for limiting the transfer of net operating losses among taxpayers were codified in 1954, both the courts and Congress attempted to impose restrictions on their transferability.

1. Judicial Restrictions on the Free Transferability of Net Operating Losses

The courts, not Congress, first placed restrictions on the free transferability of net operating losses.<sup>31</sup> The issue was squarely raised before the United States Supreme Court for the first time in 1934. In *New Colonial Ice Co. v. Helvering*,<sup>32</sup> Colonial Ice Corporation, the taxpayer's predecessor, was organized for the purpose

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treated equally. See STAFF OF THE JOINT COMM. ON TAX'N, 97TH CONG., 2D SESS., ANALYSIS OF PROPOSALS RELATING TO BROADENING THE BASE AND LOWERING THE RATES OF THE INCOME TAX 3 (1982) (the horizontal equity concept requires that "taxpayers with equal incomes should have equal tax liabilities").

For a good discussion of the role of net operating loss carryovers generally, see Peter L. Faber, *Net Operating Loss Carryovers in Corporate Acquisitions After the Tax Reform Act of 1986*, 39 U.S.C. INST. ON FED. TAX'N 2-1, ¶ 201.1 (1987).

29 I.R.C. § 172(b)(1)(A)(i) (West Supp. 1992). The entire net operating loss is first carried to the three carryback years, beginning with the earliest year, and used to offset any income generated during those years. Any unused net operating losses can then be carried forward to offset income for years following the year of loss in chronological order. I.R.C. § 172(b)(2). A taxpayer, however, may elect to relinquish any right to use the carryback period pursuant to I.R.C. § 172(b)(3). A taxpayer might choose to make such an election, for example, when the tax rates applicable to carryover years, and hence the value of the losses during those years, exceed the rates applicable to carryback years. See Faber, *supra* note 28, at 2-4.

30 I.R.C. § 172(b)(1)(A)(ii).

31 For a discussion of the early statutory limitations on the free transferability of net operating losses, see *infra* notes 56-63 and accompanying text.

32 292 U.S. 435 (1934).



of producing and selling ice. Soon after its organization, however, it became clear that the company would be unable to make a profit. Creditors and stockholders organized committees whose investigations culminated in an agreement which included plans to organize a new corporation to produce and sell ice. Accordingly, New Colonial Ice Company succeeded to the assets, liabilities, and business of the old company in 1922. The shares of Colonial Ice Corporation were retired and replaced by shares of New Colonial Ice Company. The shareholders of the old corporation became the shareholders of the new corporation. The new corporation's capital structure was substantially similar to that of the old corporation as well.<sup>33</sup>

The Supreme Court faced the issue of whether New Colonial Ice Company succeeded to the net operating losses sustained by Colonial Ice Corporation and could use such losses to offset its taxable income for the period following the reorganization.<sup>34</sup> Relying on section 204(b) of the Revenue Act of 1921,<sup>35</sup> the Court disallowed the successor corporation's use of its predecessor's net operating losses.<sup>36</sup> The Court reasoned that only the taxpayer who sustained the loss would be allowed a deduction under section 204(b), and that the net operating loss could not be transferred.<sup>37</sup> The Court rejected the contention that the new corporation was for all practical purposes the same entity as the old corporation and, therefore, was the same taxpayer. According to the Court, the two corporations were distinct taxable entities, evidenced in part by the fact that the shareholders and creditors had abandoned the old company and turned to the new corporation "because they regarded it as a distinct corporate entity and therefore free from difficulties attending the old one."<sup>38</sup> Thus, the

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33 *Id.* at 437-38.

34 *Id.* at 437.

35 Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 227, 231 (1921).

36 *New Colonial Ice*, 292 U.S. at 440.

37 The pertinent language of § 204(b) provides:

If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

Section 204(b), 42 Stat. at 231 (emphasis added).

38 *New Colonial Ice*, 292 U.S. at 441. Section 382 of the Internal Revenue Code of

Court precluded New Colonial Ice Company from utilizing the net operating losses sustained by its predecessor corporation.

Following the Supreme Court's decision in *New Colonial Ice*, a profitable corporation wishing to offset its income with a loss corporation's net operating losses could simply merge into the loss corporation, with the loss corporation as the surviving entity. Because the loss corporation's legal identity had not changed, its net operating losses would survive the merger. The combined corporations could then use those losses to offset future income.<sup>39</sup>

Just five years after it decided *New Colonial Ice*, the Supreme Court, in *Helvering v. Metropolitan Edison Co.*,<sup>40</sup> retreated somewhat from its earlier position. In that case, Metropolitan Edison acquired the assets and assumed the liabilities of Metropolitan Power Company in a transaction that, although not a true merger under state law, nevertheless was found to constitute a de facto merger. Thereafter, Metropolitan Edison liquidated a former subsidiary of Metropolitan Power Company and retired its bonds. Metropolitan Edison then deducted the subsidiary's unamortized bond discount from its gross income.<sup>41</sup> The Supreme Court allowed the deduction on the grounds that the initial transaction constituted a de facto merger, and, therefore, the surviving entity could succeed to the tax attributes of the merged corporation.<sup>42</sup> In essence, the Supreme Court's holding seemed to indicate that when one corporation merged into another, the successor corporation was in substance the same taxpayer as the one that went out of existence and, accordingly, should be entitled to use the nonsurviving corporation's deductions.<sup>43</sup>

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1954, I.R.C. § 382 (1954) (repealed 1986), overruled *New Colonial Ice*. For a discussion of § 382 under the 1954 Code, see *infra* notes 74-101 and accompanying text.

39 See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 16.02, at 16-7 (5th ed. 1987). According to one commentator, "the message of the courts [after *New Colonial Ice*] was that the law did not prohibit trafficking in loss carryovers as long as the transaction took the proper legal form." Schultz, *supra* note 25, at 63.

40 306 U.S. 522 (1939).

41 *Id.* at 524-26.

42 *Id.* at 529.

43 The Supreme Court's holding in *Metropolitan Edison* extended only to the successor corporation's deduction of unamortized bond discounts. Several circuit courts, however, later expanded that holding to encompass other tax attributes, such as unused excess profits tax credits (which are similar in concept to net operating loss carryovers). See, e.g., *E. & J. Gallo Winery v. Commissioner*, 227 F.2d 699, 705 (9th Cir. 1955); *Stanton Brewery, Inc. v. Commissioner*, 176 F.2d 573, 577 (2d Cir. 1949). But see *Jones v. Noble Drilling Co.*, 135 F.2d 721, 724-25 (10th Cir. 1943) (holding that the surviving

Although the dichotomy between the Supreme Court's holdings in *New Colonial Ice* and *Metropolitan Edison* remained, lower courts continued to apply the "entity approach" set forth in *New Colonial Ice* in non-merger cases.<sup>44</sup> The Tax Court's decision in *Alprosa Watch Corp. v. Commissioner*<sup>45</sup> represents one of the most egregious examples of a strict application of the entity approach. In *Alprosa Watch*, two individuals purchased all of the stock of Esspi Glove Corporation ("Esspi"), a company which manufactured and sold women's gloves, planning to use Esspi as a vehicle through which to sell imported watches. The day after the stock purchase, the new shareholders changed the corporation's name to Alprosa Watch Corporation ("Alprosa"), moved its place of business, discontinued the glove business, and began to sell jewelry, including watches. Shortly thereafter, the shareholders sold the assets of the glove manufacturing operation back to the former shareholders of the corporation.<sup>46</sup>

Prior to the acquisition, Esspi had accumulated unused net operating losses and excess profits credits that Alprosa wanted to use to offset the income generated after the acquisition. The Tax Court faced the issue of whether Esspi and Alprosa were, in fact, the same corporate entity so that Alprosa could utilize the pre-acquisition net operating losses and credits incurred by Esspi. The court found that the corporation was the same legal entity for tax purposes, even though it had changed its name, business location, stock ownership, and the nature of its business. Accordingly, the Tax Court permitted Alprosa to offset its post-acquisition income with the net operating losses and unused excess profits credits generated by Esspi prior to the acquisition.<sup>47</sup> The Tax Court's holding in *Alprosa Watch* carried the entity theory enunciated in *New Colonial Ice* too far by elevating form over substance and mak-

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corporation in a statutory merger was not entitled to use the merged corporation's unused dividend-paid credits following the merger; only the taxpayer to whom a deduction accrues has the right to claim such deduction).

44 See *Standard Paving Co. v. Commissioner*, 190 F.2d 330, 334 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Weber Flour Mills Co. v. Commissioner*, 82 F.2d 764, 764 (10th Cir. 1936); *Shreveport Producing & Ref. Co. v. Commissioner*, 71 F.2d 972, 972 (5th Cir.), *cert. denied*, 293 U.S. 616 (1934).

45 11 T.C. 240 (1948).

46 *Id.* at 242.

47 *Id.* at 246. In reaching its determination, the Tax Court rejected the argument that the acquisition was made solely to evade federal income taxes, citing a valid business purpose for the transaction. Thus, the court found the case of *Gregory v. Helvering*, 293 U.S. 465 (1935), inapplicable. *Alprosa Watch*, 11 T.C. at 244-45.

ing it relatively easy for a profitable corporation to "purchase" a loss corporation's unused net operating losses.<sup>48</sup>

The final judicial attempt to limit the free transferability of net operating losses prior to the application of the 1954 Code came in the landmark Supreme Court case of *Libson Shops, Inc. v. Koehler*.<sup>49</sup> In *Libson Shops*, the Court moved away from its analyses in *New Colonial Ice* and *Metropolitan Edison* and instead adopted a new standard for limiting the use of a corporation's net operating losses. *Libson Shops* involved sixteen separate corporations that operated women's retail clothing stores. A seventeenth corporation provided management services to each of the sixteen retail stores, and all seventeen corporations were commonly owned. Only three of the retail clothing stores operated at a loss. In 1949, the sixteen sales corporations were merged into the management corporation pursuant to state law, apparently for valid business reasons.<sup>50</sup> The surviving corporation attempted to offset its post-merger income with the loss carryovers sustained by the three sales corporations that were unprofitable prior to the merger.

Relying on *New Colonial Ice*, the Commissioner disallowed the deduction because the surviving corporation was not the same "taxpayer" as the merged corporations that had sustained the losses.<sup>51</sup> *Libson Shops* took the position that, as the surviving corporation in a statutory merger, it should be treated as the same legal entity as the merged corporations, citing *Metropolitan Edison* in support of its position.<sup>52</sup> Apparently rejecting the dichotomy between the entity approach developed in *New Colonial Ice* and the merger approach developed in *Metropolitan Edison*, the Supreme Court instead adopted a new "continuity-of-business-enterprise"

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48 One commentator observed that even though *Alprosa Watch* carried the holding of *New Colonial Ice* "to a logical extreme," it was interesting that the Tax Court did not cite *New Colonial Ice* anywhere in its opinion. Daniel Q. Posin, *Three Strikes Are We Out? Transfer of Loss Carryovers After the 1986 Act*, 7 VA. TAX REV. 697, 712-13 n.58 (1988).

49 353 U.S. 382 (1957). Although *Libson Shops* was decided after the enactment of the Internal Revenue Code of 1954, ch. 736, Pub. L. No. 591, 68A Stat. 1 (repealed 1986), the events giving rise to the case occurred prior to 1954; hence, the case was governed by the Internal Revenue Code of 1939, ch. 2, Pub. L. No. 1, 53 Stat. 1 (repealed 1954). For a discussion of the provisions limiting the free transferability of net operating losses under the 1954 Code, see *infra* notes 64-107 and accompanying text.

50 While the Supreme Court's opinion does not disclose the reason for the merger, its holding that the "principal purpose" of the merger was not tax evasion implies that a valid business purpose existed. *Libson Shops*, 353 U.S. at 389.

51 *Id.* at 385-86.

52 *Id.* at 386.

test.<sup>53</sup> Using this test, the Supreme Court held that the surviving corporation could not succeed to the prior entities' tax attributes because the surviving corporation was not substantially the same business as the entities that had produced the losses.<sup>54</sup>

*Libson Shops* provided the Internal Revenue Service and the courts with a powerful tool to prevent the transfer of net operating losses between taxpayers. Although the case was decided under the provisions of the 1939 Code, some courts ruled that *Libson Shops*' continuity-of-business-enterprise doctrine remained viable even after the 1954 Code.<sup>55</sup>

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53 The "continuity-of-business-enterprise" concept was actually not new to the tax law. It had come into existence much earlier in connection with tax-free reorganizations under § 368 of the Code. See BITTKER & EUSTICE, *supra* note 39, at 14-171 to 14-174. *Libson Shops* was merely the first instance in which the Supreme Court employed a continuity-of-business-enterprise test to disallow a taxpayer's use of its predecessor's net operating losses.

54 *Libson Shops*, 353 U.S. at 389-90. The Court reasoned that the purpose of the net operating loss carryover provisions was to:

ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to setoff its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year. There is, however, no indication in their legislative history that these provisions were designed to permit the averaging of the pre-merger losses of one business with the post-merger income of some other business which had been operated and taxed separately before the merger. What history there is suggests that Congress primarily was concerned with the fluctuating income of a single business.

*Id.* at 386-87 (footnotes omitted). Because the three corporations that had incurred the net operating losses prior to the merger remained unprofitable as divisions following the merger, it was apparent that the surviving corporation was attempting to offset post-merger profits attributable to its other successful divisions against pre-merger net operating losses of its loss constituents. Accordingly, the Court held that the income and losses were not produced by substantially the same businesses and disallowed the deduction. *Id.* at 390.

55 Compare *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737, 742 (8th Cir. 1968) (agreeing with the trial court that "in enacting sections 381 and 382 of the 1954 Code, Congress intended to substitute statutory rules for court-made law and the precedential value of the *Libson Shops* decision has been destroyed") and *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713, 716 (9th Cir. 1965) ("[b]y enacting the 1954 Code, Congress destroyed the precedential value of the rule of decision of *Libson Shops*") with *National Tea Co. & Consol. Subsidiaries v. Commissioner*, 83 T.C. 8, 19 (1984) ("we are not prepared to accept petitioner's argument that *Libson Shops* has no application under the 1954 Code"). See also AMERICAN LAW INSTITUTE, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, FEDERAL INCOME TAX PROJECT-SUBCHAPTER C 204 (1982) [hereinafter ALI SUBCHAPTER C PROJECT].

The *Libson Shops* doctrine continued to be invoked, with varying degrees of success, until 1986, when Congress made clear its intention to lay it to rest in the legislative history of the Tax Reform Act of 1986. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt.

## 2. Early Statutory Limitations on the Free Transferability of Net Operating Losses

In 1943, Congress entered the fray by adding section 129 to the Internal Revenue Code of 1939.<sup>56</sup> Congress enacted section 129 in order to provide statutory limitations on the transferability of certain deductions and tax credits.<sup>57</sup> Specifically, the section was intended to prevent trafficking in the net operating loss deduction.<sup>58</sup>

Section 129 applied to certain stock or asset acquisitions<sup>59</sup> if the "principal purpose" of the acquisition was the evasion or avoidance of federal income tax through the use of a deduction, credit, or other allowance that the acquiring party would not otherwise enjoy.<sup>60</sup> If section 129 applied to an acquisition, the Commissioner would disallow the tax benefit.<sup>61</sup>

Although Congress purposely left the provisions of section 129 very broad in order to cover all forms of tax avoidance

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2, at 194 (1986), *reprinted in* 1986 U.S.C.A.N. 4077, 4282 ("[t]he conferees intend . . . that the *Libson Shops* doctrine will have no application to transactions subject to the provisions of the conference agreement [the Tax Reform Act of 1986]").

56 Revenue Act of 1943, Pub. L. No. 78-235, ch. 63, § 129, 58 Stat. 21, 47 (1944) (recodified as § 269 of the Internal Revenue Code of 1954).

57 See *infra* note 58.

58 H.R. REP. NO. 871, 78th Cong., 1st Sess. 49 (1943) ("[t]his section is designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability"); see also S. REP. NO. 627, 78th Cong., 1st Sess. 49 (1943) ("[t]he objective of the section . . . is to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the code, particularly those of the type represented by the recently developed practice of corporations with large excess profits (or the interests controlling such corporations) acquiring corporations with current, past, or prospective losses or deductions, deficits, or current or unused excess profits credits, for the purpose of reducing income and excess profits taxes"). Section 129 was the predecessor to § 269 of the Internal Revenue Code of 1954. See *infra* notes 68-73 and accompanying text.

59 In a stock acquisition, § 129 applied to any person or persons who acquired control of a corporation, directly or indirectly. See § 129, 58 Stat. at 47. Control was defined in section 129(a) as stock possessing at least 50% of the acquired corporation's total voting stock or at least 50% of the total value of all shares of the acquired corporation's stock. *Id.* The section also applied to an asset acquisition in which a corporation acquired property of another corporation, which the acquiring corporation did not control prior to the acquisition and in which the acquiring corporation took a transferred basis. *Id.*

60 *Id.*

61 *Id.* The statute further gave the Internal Revenue Service broad discretion to allow a partial deduction, credit, or other tax benefit for that part of the transaction that did not constitute tax avoidance. See § 129(b)(1), 58 Stat. at 48.

schemes,<sup>62</sup> the section nevertheless proved largely ineffectual because it was virtually impossible for the Internal Revenue Service to prove that the taxpayer's "principal purpose" behind an acquisition was the avoidance of federal income taxes. As long as the taxpayer had a substantial business purpose for entering into the transaction, section 129 did not apply.<sup>63</sup>

*B. Net Operating Loss Carryovers Under the 1954 Code:  
Congress Imposes Objective and Subjective  
Limitations on Net Operating Loss Transfers*

The limited success of the Internal Revenue Service in preventing the free transferability of net operating loss carryovers led Congress to enact a comprehensive statutory scheme restricting the use of net operating loss carryovers in certain transactions.<sup>64</sup>

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62 See *supra* note 58.

63 See, e.g., *WAGE, Inc. v. Commissioner*, 19 T.C. 249, 256 (1952); *Alcorn Wholesale Co. v. Commissioner*, 16 T.C. 75, 89 (1951); *Berland's Inc. v. Commissioner*, 16 T.C. 182, 188 (1951); *Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411, 417 (1948). It is interesting to note that the original version of § 129 proposed by the House suggested that the section was applicable any time that one of the principal purposes of the transaction was to avoid taxes. Conversely, the Senate version of § 129 made it clear that "principal purpose" meant that the tax avoidance purpose had to outrank or exceed in importance any other purpose for the transaction. The Senate's version of § 129 was ultimately adopted by the Conference Committee and proved to be the downfall of that provision. See H.R. CONF. REP. NO. 1079, 78th Cong., 2d Sess. 23 (1944).

Although the "principal purpose" standard of § 129 remained unchanged, the Service began to enjoy some success in its challenges under § 129 in 1957. Previously, courts had placed the burden on the Service to prove that the principal purpose of an acquisition was to avoid taxes. If the taxpayer could show a valid business purpose for the transaction, the Service failed to carry its burden. In 1957, however, the Ninth Circuit, in *American Pipe & Steel Corp. v. Commissioner*, 243 F.2d 125, 126-27 (9th Cir.), *cert. denied*, 355 U.S. 906 (1957), shifted the initial burden to the taxpayer to demonstrate a "substantial" business purpose for the acquisition. Taxpayers found it virtually impossible to discharge this burden successfully, particularly where the taxpayer had acquired a loss corporation. See, e.g., *Commissioner v. British Motor Car Distrib., Ltd.*, 278 F.2d 392 (9th Cir. 1960); *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir.), *cert. denied*, 361 U.S. 816 (1959). Although each of the foregoing cases in which the Service successfully invoked § 129 to disallow the transfer of net operating losses between taxpayers was decided after the adoption of the Internal Revenue Code of 1954, all of the cases involve tax years prior to 1954. Accordingly, § 129 of the 1939 Code, and not § 269 of the 1954 Code, discussed *infra* notes 68-73 and accompanying text, was applicable.

64 H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4067. According to the legislative history to the 1954 Code, Congress established a comprehensive scheme largely in response to the myriad legislative and judicial tests that had developed over the years, many of which were nebulous and inconsistent. *Id.*; S. REP. NO. 1622, 83d Cong., 2d Sess. 53, 284-86 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4922-25. As one commentator aptly described,

As part of the 1954 Code, Congress adopted a twofold approach aimed at eliminating the perceived abuse of trafficking in net operating losses. First, it retained the subjective "tax avoidance" test of section 129 of the 1939 Code, recodifying it as section 269 of the Internal Revenue Code of 1954.<sup>65</sup> Second, it developed an objective test for limiting the use of a corporation's net operating losses following certain prescribed changes in the ownership of such corporation.<sup>66</sup> Although the subjective test of section 269 enabled the Service to limit net operating loss transfers in the most egregious cases, the objective test of section 382 proved more successful in limiting such transfers.<sup>67</sup>

### 1. Section 269 of the 1954 Code

Section 269 of the 1954 Code recodified the subjective tax avoidance test enunciated in section 129 of the 1939 Code, but added one important subsection in an attempt to ease the burden placed on the Commissioner to demonstrate a tax avoidance motive. Section 269(c) established a presumption of tax avoidance in cases where the purchase price paid for a corporation by an acquiring party was substantially disproportionate to the aggregate of the total adjusted bases of the properties acquired plus the tax benefits available as a result of the acquisition.<sup>68</sup> The primary effect of this presumption was to impose upon the acquiring corporation the burden of proving that it did not have a tax avoidance motive.<sup>69</sup> Thus, under the presumption established in section

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prior to enactment of the 1954 Code, the question of whether a net operating loss deduction survived a corporate change of ownership turned upon at least three very different standards: the "entity" approach of *New Colonial Ice*, as modified by *Metropolitan Edison*; the statutory "tax avoidance" test; and the "business continuity" requirement of *Libson Shops*.

Yin, *supra* note 25, at 41-6.

65 I.R.C. § 269 (1954) (amended 1963, 1983, and 1988); see *infra* notes 68-73 and accompanying text.

66 I.R.C. § 382 (1954) (amended 1964, 1976, 1980, 1981, 1984, 1986, 1987, 1988, and 1989); see *infra* notes 74-107 and accompanying text.

67 See *infra* notes 68-107 and accompanying text.

68 I.R.C. § 269(c) (1954) (repealed 1976).

69 H.R. REP. NO. 1337, 83d Cong., 2d Sess. 32 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4057, states that § 269(c)

has the effect of throwing on the corporation the burden of proving that there was no purpose of evasion or avoidance in cases where the consideration paid in acquiring control of another corporation, or corporation property, is substantially disproportionate to the sum of the adjusted basis of the property and the tax



269(c), an acquiring party could only use the acquired corporation's net operating losses and other tax benefits if it paid for them.

Unfortunately, it soon became clear that the presumption embodied in section 269(c) ran contrary to its intended purpose, largely because "tax avoidance motives would be more apt to be present where the value of 'tax benefits' was paid for, than they would be where the 'tax benefits' were not given weight."<sup>70</sup> Accordingly, the presumption received little favor in the courts,<sup>71</sup> and Congress eventually repealed it in 1976.<sup>72</sup> Section 269 was not amended by the Tax Reform Act of 1986 and remains in effect today.<sup>73</sup>

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benefits not otherwise available.

*Id.*

70 See H.R. REP. NO. 658, 94th Cong., 2d Sess. 377 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3274; S. REP. NO. 938, 94th Cong., 2d Sess., pt. 1, at 497-98 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3922-23.

71 See, e.g., *Glen Raven Mills, Inc. v. Commissioner*, 59 T.C. 1, 16 (1972); *Industrial Suppliers, Inc. v. Commissioner*, 50 T.C. 635, 645-46 (1968); *H.F. Ramsey Co., Inc. v. Commissioner*, 43 T.C. 500, 517 (1965).

72 Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(38), 1976 U.S.C.C.A.N. (90 Stat.) 1520, 1771 (codified at I.R.C. § 269 (1988)).

73 See I.R.C. § 269 (1988). Some factors that have been considered in determining whether the tax avoidance motive required by § 269 is present include: (1) whether the parties knew of the existence of the acquired corporation's favorable tax benefits when they entered into the transaction; (2) whether the corporation being acquired was a viable business and would continue to be following the acquisition, or whether it was instead merely a corporate shell; (3) whether acquiring the target corporation would enhance the business activities of the acquiring corporation, either by moving into new markets or by diversifying its business or investment portfolio; (4) the value of the tax benefits being acquired as a percentage of the value of the business being acquired (determined by its earning potential); (5) whether the tax benefits would have been available to the acquirer even in the absence of the acquisition; and (6) whether the form of the acquisition (either a stock purchase rather than an asset purchase or a nontaxable reorganization rather than a taxable acquisition) was mandated by business considerations apart from tax implications. BITTKER & EUSTICE, *supra* note 39, at 16-44 to 16-45, and cases cited therein. For a recent case applying these factors to a § 269 determination, see *In re Federated Dep't Stores, Inc.*, 135 B.R. 962 (Bankr. S.D. Ohio 1992), in which the bankruptcy court found that Federated acquired all of the outstanding stock of Twin Fairs Distributors Corporation and over twenty-six million dollars in Twin Fairs' net operating losses for the principal purpose of business expansion, and not tax avoidance. *Id.* at 970. Thus, the court refused to apply § 269 to disallow Federated's post-acquisition use of the net operating losses generated by Twin Fairs before the acquisition. *Id.* at 972.

As discussed *infra* notes 209-16 and accompanying text, § 269 has taken on new importance in connection with transactions involving the attempted transfer of net operating losses of a bankrupt corporation in a Title 11 proceeding.

## 2. Sections 381 and 382 of the 1954 Code

In addition to the subjective tax avoidance test of section 269, the comprehensive scheme enacted by Congress in 1954 included dual provisions designed to establish objective guidelines governing the transactions in which an acquiring corporation could succeed to the tax attributes of an acquired corporation (section 381), as well as provisions for limiting the transferability of net operating losses upon the occurrence of certain prescribed events (section 382). First, section 381 of the 1954 Code allowed an acquiring corporation to succeed to the net operating losses and other tax attributes<sup>74</sup> of another corporation acquired either (1) in a tax-free asset acquisition; or (2) in a tax-free liquidation of an eighty-percent-owned subsidiary.<sup>75</sup> In enacting section 381, Congress rejected the entity approach enunciated in *New Colonial Ice*—that is, that the only way in which to preserve a loss corporation's net operating losses was to continue that corporation's legal identity.<sup>76</sup> By allowing net operating losses to be passed from one cor-

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74 Although the net operating loss carryover is one significant tax attribute governed by § 381, the current version of that provision lists no less than 21 tax attributes that survive a tax-free reorganization or liquidation, including earnings and profits, capital loss carryovers, accounting methods, and excess charitable contributions. See I.R.C. § 381(c)(1)-(25) (West Supp. 1992).

75 I.R.C. § 381(a) (1954). Thus, § 381(a) applies in a liquidation of a controlled subsidiary governed by § 332 as well as a reorganization meeting the requirements of § 368(a)(1)(A), (C), (D), (F), or (G). See I.R.C. § 381(a)(1)-(2) (1988). Section 381 has survived numerous revisions to the Code with only minor amendments, such as adding G reorganizations, those involving corporations in Title 11 proceedings, to its list of tax-free asset reorganizations. See Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 4(g), 94 Stat. 3389, 3404 (1980); see also *infra* notes 121-30 and accompanying text.

Congress also amended § 381 several times to expand the list of tax attributes governed by its provisions. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2320, 2321 (1986); Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 208, 221(b)(1), 95 Stat. 172, 226, 246 (1981); Tax Reform Act of 1976, Pub. L. No. 94-455, § 1601(e), 90 Stat. 1520, 1746 (1976); Life Insurance Company Tax Act of 1959, Pub. L. No. 86-69, § 3(c), 73 Stat. 112, 139 (1959). For a detailed discussion of the technical rules involving the operation of § 381, see BITTKER & EUSTICE, *supra* note 39, at 16-15 to 16-34; Posin, *supra* note 48, at 705-11.

76 H.R. REP. NO. 1337, 83d Cong., 2d Sess. 41 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4066-67; S. REP. NO. 1622, 83d Cong., 2d Sess. 52 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4683-84. The legislative history generally provides that a decision as to whether a net operating loss carryover will be permitted:

should be based upon economic realities rather than upon artificialities as the legal form of the reorganization.

. . . .

The new rules enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial

poration to another in certain tax-free reorganizations and liquidations, Congress reestablished the net operating loss carryover as a valuable commodity. As one commentator explained, "section 381 deviates from the pure averaging rationale for loss carryovers and instead follows a policy that allows loss corporation shareholders to recoup a portion of their losses in the form of consideration for the loss carryover. As a result, net operating loss carryovers became a marketable corporate asset."<sup>77</sup>

Recognizing that section 381 provided an incentive for profitable corporations to purchase loss corporations in order to succeed to their net operating losses, Congress also enacted section 382 as part of the 1954 Code in order to limit the transferability of net operating losses in certain corporate transactions.<sup>78</sup> Section 382 contained two objective standards governing the reduction of net operating losses: section 382(a) applied to taxable acquisitions while section 382(b) applied to nontaxable reorganizations. Under section 382(a), a corporation's net operating losses were eliminated completely if two circumstances were present. First, the corporation must have experienced a change in the control of its stock.<sup>79</sup> The requisite change in control occurred if, at the end of any taxable year of the loss corporation, the stock ownership of its ten largest shareholders had increased by fifty percentage points or more<sup>80</sup> than their stock ownership at the beginning of

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legal requirements which now exist under court-made law. Tax results of liquidations or reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise.

*Id.*; see also BITTKER & EUSTICE, *supra* note 39, at 16-19 ("The strict continuity of legal entity approach with respect to the survival of corporate tax attributes, inspired by *New Colonial* . . . was rejected by the drafters of the 1954 Code").

<sup>77</sup> Simmons, *supra* note 25, at 1058.

<sup>78</sup> See I.R.C. § 382 (1954); see also H.R. REP. NO. 1337, 83d Cong., 2d Sess. 42 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4067 (providing that "[t]his special limitation on net operating loss carryovers provides an objective standard governing the availability of a major tax benefit which has been abused through trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss.").

<sup>79</sup> I.R.C. § 382(a)(1) (1954) (amended 1976, 1978, and 1986).

<sup>80</sup> A fifty *percentage point* increase in stockholdings is not the same as a fifty *percent* increase. Consider, for example, a shareholder owning 10 shares out of 100 outstanding shares of stock (a 10% shareholder). If his stock ownership increased to 15 shares, he would have experienced a fifty percent increase in his holdings, but only a five percentage point increase. In order to meet § 382(a)'s change-of-control test, the shareholder would have to increase from 10 shares to 60 shares. This concept of percentage point increases carries into the post-1986 version of § 382 as well. See *infra* notes 156-59 and

the taxable year or at the beginning of the prior taxable year,<sup>81</sup> and the new stock had been acquired in a taxable transaction (the "change-of-control" test).<sup>82</sup> Second, the corporation must have failed to carry on a trade or business substantially similar to the business conducted by it before the change in control occurred (the "continuity-of-business" test).<sup>83</sup>

Because the change-of-control test contained in the first prong of section 382(a) was fairly mechanical in operation, the Service had little trouble applying it in practice. On the other hand, the second prong of section 382(a), the continuity-of-business test, provided both the Service and taxpayers more difficulty. The Service took a strict view of this continuity-of-business requirement, providing in regulations that a corporation would not be deemed to carry on substantially the same business if it discontinued "more than a minor portion" of the business that it carried on before the change in control occurred.<sup>84</sup> Furthermore, under the regulations, if the corporation changed its location following the change in control, the corporation would fail the continuity-of-business test if the location change altered its business in any significant way.<sup>85</sup> Despite the Service's strict interpretation of the continuity-of-business requirement, many courts adopted a more lenient interpretation of the statutory requirement.<sup>86</sup>

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accompanying text.

81 I.R.C. § 382(a)(1)(A) (1954) (amended 1976, 1978, and 1986). For purposes of determining control, stock ownership percentages were calculated based upon the fair market value of the corporation's outstanding stock, rather than on the basis of the outstanding number of shares. *Id.* Moreover, the constructive ownership rules of § 318(a) applied in determining stock ownership for this purpose. See I.R.C. § 382(a)(3) (1954) (amended 1976, 1978, and 1986).

82 A taxable transaction would occur if either the stock was acquired by purchase, defined as a transaction in which the acquirer received a cost basis in the stock, or by reason of a stock redemption. See I.R.C. § 382(a)(1)(B), (a)(4) (1954) (for full text see COMPLETE INTERNAL REVENUE CODE OF 1954 25,345-46 n. § 382 (Apr. 2, 1980 ed., Prentice-Hall, Inc.)).

83 I.R.C. § 382(a)(1)(C) (1954) (for full text see COMPLETE INTERNAL REVENUE CODE OF 1954 25,345-46 n. § 382 (Apr. 2, 1980 ed., Prentice-Hall, Inc.)).

84 Treas. Reg. § 1.382(a)-1(h)(7) (1963). In determining whether the discontinuance constituted "more than a minor portion" of the loss corporation's business, the regulations provided that weight would be given to whether the discontinuance had the effect of enabling a corporation to utilize loss carryovers to offset income of a business other than that business which produced the losses. *Id.*

85 Treas. Reg. § 1.382(a)-1(h)(9) (1963). Some items taken into account under the regulations included whether the business's employees, equipment, customers, and historical geographical areas were changed as a result of the relocation. *Id.*; see also Treas. Reg. § 1.382(a)-1(h)(5) (1963).

86 For example, one court allowed a purchaser to retain the acquired corporation's

While section 382(a) applied to taxable acquisitions, such as stock purchases and redemptions, section 382(b) sought to impose limitations on the transferability of net operating loss carryovers in certain nontaxable transactions, such as tax-free asset reorganizations.<sup>87</sup> Generally, when a corporation acquires the assets and business of a loss corporation in a tax-free reorganization, it succeeds to that corporation's net operating losses and other tax attributes under section 381(a) of the Code. As originally enacted in 1954, however, section 382(b) required the reduction of a loss corporation's net operating losses otherwise available as carryovers to an acquiring corporation if the shareholders of the loss corporation immediately before the reorganization owned less than twenty percent of the outstanding stock of the acquiring corporation after the reorganization.<sup>88</sup> In such a case, the loss corporation's net operating losses were reduced by five percent for each one percent less than the requisite twenty-percent minimum owned by the loss corporation's shareholders. For example, if the shareholders of the loss corporation owned only twelve percent of the acquiring corporation following the reorganization, the corporation's net operating losses would be reduced by forty percent (five percent times eight).<sup>89</sup> Thus, section 382(b) was specifically designed to address trafficking in a loss corporation's net operating losses by profitable corporations.<sup>90</sup>

Soon after section 382 was enacted in 1954, it became apparent that it was inadequate in several respects. First, section 382 was difficult to justify from a policy standpoint. The most significant

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net operating losses despite the fact that the corporation's business location was changed after the purchase, a new line of business was added, and the corporation's historical employees were replaced with new ones. See *Commissioner v. Goodwin Crockery Co.*, 37 T.C. 355, 363-64, *aff'd*, 315 F.2d 110 (6th Cir. 1963). For other cases adopting the more lenient approach to the continuity-of-business test, see *Koppers Co. v. United States*, 229 F. Supp. 159 (W.D. Pa. 1964); *H.F. Ramsey Co. v. Commissioner*, 43 T.C. 500 (1965).

87 I.R.C. § 382(b) (1954) (amended 1976, 1978, 1984, and 1986).

88 The calculation of stock ownership for purposes of the twenty-percent test was based on the fair market value of the acquiring corporation's outstanding stock. See I.R.C. § 382(b)(1)(B) (1954). Moreover, under the original version of § 382(b) enacted in 1954, only those reorganizations qualifying under § 368(a) as A, C, D, or F reorganizations were within the purview of § 382(b). So-called G reorganizations, those involving a corporation reorganizing in a Title 11 bankruptcy proceeding, were later added to the class of reorganizations governed by § 382(b). See *Bankruptcy Tax Act of 1980*, Pub. L. No. 96-589, § 4(g), 94 Stat. 3404 (1980); see also *infra* notes 121-30 and accompanying text.

89 I.R.C. § 382(b)(2) (1954).

90 See S. REP. NO. 1622, 83d Cong., 2d Sess. 285 (1954), *reprinted in* 1954 U.S.C.A.N. 4621, 4924.

problem was that section 382 produced wildly divergent tax results based solely upon whether a transaction took the form of a taxable purchase or a tax-free reorganization, with no readily ascertainable policy justification for such inconsistent results.<sup>91</sup> For example, even if nearly all of a loss corporation's stock changed hands, the corporation would still be entitled to retain all of its net operating loss carryovers if it carried on substantially the same business after the change in control, and the new shareholders obtained their stock in taxable transactions. The corporation's net operating losses would be reduced dramatically, however, if the change in control occurred as a result of a tax-free asset reorganization.<sup>92</sup>

On the other hand, tax-free reorganizations received more favorable treatment in certain respects. For example, Congress imposed only a twenty percent continuity-of-interest requirement for a tax-free reorganization, whereas it imposed a fifty percent continuity-of-interest requirement for taxable purchases.<sup>93</sup> Similarly, net operating loss carryovers were eliminated entirely if the purchase limitations of section 382(a) applied, but were only reduced proportionately if the reorganization rules came into play.<sup>94</sup>

Section 382 suffered from several technical defects as well. For example, so-called B reorganizations,<sup>95</sup> those involving a tax-free exchange of stock for stock, were not subject to either type of limitation.<sup>96</sup> Because such reorganizations were nontaxable transactions, section 382(a), which involved only taxable purchases, did not apply. Section 382(b) also did not apply because, by its terms, it was only applicable to asset reorganizations and not stock reorganizations. Thus, a profitable corporation could exchange a portion of its stock for stock of a loss corporation, wait a reasonable

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91 See S. REP. NO. 938, 94th Cong., 2d Sess., pt. 1, at 202 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3633-34; Posin, *supra* note 48, at 716.

92 See Yin, *supra* note 25, at 41-7 to 41-8. The author suggests that one example of how this nearly complete elimination of NOLs could occur is if a "loss corporation 'minnow' were swallowed by a profitable 'whale,' with former shareholders of the loss corporation obtaining stock in the acquiring corporation representing only a tiny percentage of its total outstanding stock." *Id.* at 41-8 n.20.

93 S. REP. NO. 938, *supra* note 91, at 202, *reprinted in* 1976 U.S.C.C.A.N. at 3634.

94 *Id.*; see also Yin, *supra* note 25, at 41-8.

95 I.R.C. § 368(a)(1)(B) (1988).

96 STAFF OF SENATE FIN. COMM., 99TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985, at 34 (Comm. Print 1985) [hereinafter SENATE FIN. COMM. STAFF FINAL REPORT].

period of time before liquidating the loss corporation, and then succeed to the loss corporation's net operating loss carryovers without being subject to any of the section 382 limitations.<sup>97</sup>

Another technical defect inherent in section 382(b) was its inability to limit the transferability of net operating losses in a triangular reorganization. In a triangular reorganization, a parent corporation would establish a subsidiary, or use an existing subsidiary, to acquire a loss corporation. As part of the merger of the loss corporation into the subsidiary, the loss corporation's shareholders would receive stock of the parent corporation. Pursuant to section 382(b)(6), however, the twenty-percent minimum ownership provision was determined by treating the loss corporation's former shareholders as having received stock of the subsidiary equal in value to the stock that they actually received in the parent corporation.<sup>98</sup> This provision allowed large corporations to succeed to the net operating loss carryovers of small corporations through the use of a triangular reorganization that left the acquired corporation's shareholders with only a tiny percentage of the large corporation's stock. Accordingly, section 382(b)(6) afforded taxpayers the ability to circumvent the limitations of section 382(b) and encouraged trafficking in net operating losses.<sup>99</sup>

Finally, many commentators criticized the continuity-of-business requirement on the grounds that it ran contrary to sound business judgment because it required an unprofitable business to remain intact simply for tax purposes.<sup>100</sup> Moreover, the continuity-of-business requirement was difficult to apply in practice because it required a case-by-case analysis, thereby converting the

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97 See, e.g., S. REP. NO. 938, *supra* note 91, at 202, *reprinted in* 1976 U.S.C.C.A.N. at 3634. However, if an acquiring corporation engaged in a B reorganization and followed it promptly by a liquidation of the acquired corporation, both courts and the Service treated it as a C reorganization, governed by the limitations of § 382(b). See, e.g., *Resorts Int'l, Inc. v. Commissioner*, 511 F.2d 107, 110 (5th Cir. 1975); *Treas. Reg. § 1.382(b)-1(a)(6)* (1963); *Rev. Rul. 67-274*, 1967-2 C.B. 141. Some commentators also believed that transactions falling within the purview of § 351, governing tax-free incorporations, also fell outside the purview of both the section 382(a) and (b) limitations. See Yin, *supra* note 25, at 41-8.

98 I.R.C. § 382(b)(6) (1954).

99 See S. REP. NO. 938, *supra* note 91, at 202-03, *reprinted in* 1976 U.S.C.C.A.N. at 3633-34; Posin, *supra* note 48, at 718-19; Robert A. Rizzi, *Section 382 and the Trigger Rules: Is Congress Beating a Dead Horse?*, 14 J. CORP. TAX'N 99, 107 (1987).

100 See SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 68-69; S. REP. NO. 938, *supra* note 91, at 202, *reprinted in* 1976 U.S.C.C.A.N. at 3634; see also AMERICAN LAW INST., *FED. INCOME, ESTATE AND GIFT TAX PROJECT-INCOME TAX PROBLEMS OF CORPS. AND SHAREHOLDERS* 339 (1958).

purportedly objective test of section 382 into a subjective determination akin to that set forth in section 269.<sup>101</sup>

These internal inconsistencies and technical defects inherent in the 1954 version of section 382 led Congress to overhaul the provision completely as part of the Tax Reform Act of 1976.<sup>102</sup> The 1976 Act changes sought to equalize the treatment of taxable purchases and tax-free reorganizations involving loss corporations by (1) eliminating the continuity-of-business requirement of section 382(a); (2) raising the change-of-control test from fifty to sixty percentage points, with a concomitant increase in the shareholder continuity test of section 382(b) from twenty to forty percent; and (3) replacing section 382(a)'s total net operating loss disallowance provision with a proportionate reduction similar to that set forth in section 382(b).<sup>103</sup> Additionally, the 1976 Act attempted to correct the technical defects inherent in the prior version of section 382 by (1) treating section 351 transactions as taxable purchases governed by section 382(a); (2) including B reorganizations within the ambit of section 382(b); and (3) measuring shareholder continuity-of-interest in triangular reorganiza-

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101 Posin, *supra* note 48, at 717.

102 Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(e), (g)(2), (3), 90 Stat. 1520, 1599, 1604-05 (1976). It should also be noted that, prior to the proposed amendments to § 382 in 1976, the Treasury Department sought to limit the use of a corporation's net operating losses in certain circumstances involving corporations filing consolidated tax returns. In 1966, the Treasury promulgated regulations that established the "separate return limitation year" ("SRLY") and the "consolidated return change of ownership" ("CRCO") limitations on the use of net operating losses of certain members of a consolidated group of corporations. Under the SRLY rules, a new member joining a consolidated group can generally use its losses incurred prior to joining the group to offset its own income generated after joining the consolidated group, but cannot use its losses to offset the income generated by other members of the group. See Treas. Reg. § 1.1502-1(f), -15(a), -21(c) (1966). The CRCO rules provide that, if a common parent of a consolidated group undergoes a fifty percentage point change in the ownership of its stock within a two-year period, losses generated by members of the group before the ownership change can only be used to offset income generated by those same members after the ownership change. See Treas. Reg. § 1.1502-1(g), -21(d) (1966).

On January 29, 1991, however, the Service promulgated proposed regulations designed to repeal the CRCO limitations, as they applied to net operating and capital losses, on a prospective basis. See Prop. Treas. Reg. § 1.1502-21(d)(1), 56 Fed. Reg. 4228 (1991). Although a detailed discussion of the SRLY and CRCO rules is beyond the scope of this Article, see Faber, *supra* note 28, at 2-9 to 2-11 for an excellent discussion of the SRLY rules, and Errol G. Golub, *The NOL: Yesterday, Today and Tomorrow*, 45 N.Y.U. INST. ON FED. TAX'N 2-1, 2-12 to 2-13 (1987), for a discussion of the CRCO rules.

103 I.R.C. § 382(a), (b) (1976) (repealed 1986); see also BITTKER & EUSTICE, *supra* note 39, at 16-54 to 16-55.



tions by reference to the shareholders' interests in stock of the parent, rather than that of the subsidiary.<sup>104</sup>

Although the provisions of the 1976 Act remedied many perceived deficiencies in section 382, the provisions were hastily drafted and extraordinarily complex.<sup>105</sup> Because a number of commentators roundly criticized these provisions, and because they were the subject of concerted lobbying efforts,<sup>106</sup> Congress postponed their effective date several times and eventually repealed them retroactively as part of the Tax Reform Act of 1986.<sup>107</sup>

### 3. Amendments Made By the Bankruptcy Tax Act of 1980

Although the courts and Congress had been imposing judicial and statutory restrictions on the free transferability of net operating losses since 1934, it was not until 1980, two years after the enactment of the Bankruptcy Code,<sup>108</sup> that Congress first afforded special treatment to the net operating losses of corporations seeking bankruptcy protection. In an effort to facilitate the rehabilitation of corporations attempting to reorganize in bankruptcy, Congress enacted three new provisions as part of the Bankruptcy Tax Act of 1980: (1) a provision exempting corporations in Title 11 proceedings from the harsh application of certain discharge-of-indebtedness rules;<sup>109</sup> (2) an insolvency reorganization

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104 I.R.C. § 382(a), (b).

105 See Faber, *supra* note 28, at 2-18.

106 See Rizzi, *supra* note 99, at 108 n.42.

107 The 1976 Act, as originally enacted, delayed the effective date of the § 382 provisions until 1978. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(c), 90 Stat. 1520, 1606 (1976). Soon thereafter, Congress delayed the effective date of these provisions until 1980. See Revenue Act of 1978, Pub. L. No. 95-600, § 368, 92 Stat. 2763, 2857 (1978). The effective date of the provisions was again postponed until 1982 by the Fringe Benefit Regulation-Issuance-Prohibition Act, Pub. L. No. 96-167, § 9(e), 93 Stat. 1275, 1279 (1979). The effective date of the provisions was then delayed until 1984 by the Black Lung Benefits Revenue Act of 1981, Pub. L. No. 97-119, § 111, 95 Stat. 1635, 1640 (1981), and the effective date was postponed for another two years by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 62(b)(1), 98 Stat. 494, 583 (1984). The 1976 Act provisions were finally repealed retroactively as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 621(e)(1), 100 Stat. 2085, 2266 (1986).

108 Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990)).

109 Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389, 3389 (1980) (codified in scattered sections of 26 U.S.C.); see also S. REP. NO. 1035, 96th Cong., 2d Sess. 1 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7017.

provision;<sup>110</sup> and (3) an amendment to section 382(b) treating creditors as shareholders in Title 11 proceedings.<sup>111</sup>

The Bankruptcy Tax Act contained extensive provisions dealing with a corporation's indebtedness that is discharged in a Title 11 proceeding.<sup>112</sup> Generally, when a taxpayer's debt is discharged for less than its face amount, the taxpayer must include that difference in gross income as discharge-of-indebtedness income.<sup>113</sup> Under the Bankruptcy Tax Act, however, a corporate taxpayer involved in a Title 11 proceeding did not have to include the discharge-of-indebtedness amount in its income,<sup>114</sup> as long as the bankruptcy court approved the debt discharge.<sup>115</sup> In exchange for this income exclusion, the Act required that the amount of the discharged debt reduce the debtor corporation's tax attributes in the following order: first, its net operating losses; second, certain tax credits, such as the general business credit; third, its capital loss carryovers; fourth, the basis of its assets; and fifth, its foreign tax credit carryovers (the "debt discharge rule").<sup>116</sup> The Act further provided that the debt discharge rule would not apply if the debtor corporation issued stock in exchange for the debt discharged.<sup>117</sup> This provision codified a rule developed by an extensive body of case law which had come to be known as the stock-for-debt exception.<sup>118</sup> The stock-for-debt exception applied re-

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110 Bankruptcy Tax Act of 1980, § 4(a), 94 Stat. at 3401 (codified in 26 U.S.C. § 368(a)); see also S. REP. NO. 1035, *supra* note 109, at 35, reprinted in 1980 U.S.C.C.A.N. at 7049.

111 Bankruptcy Tax Act of 1980, § 2(d), 94 Stat. at 3396 (codified in 26 U.S.C. § 382(b)(7)(repealed 1986)); see also S. REP. NO. 1035, *supra* note 109, at 38, reprinted in 1980 U.S.C.C.A.N. at 7052.

112 The provisions also encompassed taxpayers other than corporations and, in addition, included debtors that were insolvent but not involved in a Title 11 proceeding. The remainder of this discussion, however, will focus on corporations in Title 11 proceedings.

113 I.R.C. § 61(a)(12) (1988); see also *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

114 Bankruptcy Tax Act of 1980, § 2, 94 Stat. at 3389; I.R.C. § 108(a)(1)(A) (1988).

115 I.R.C. § 108(d)(2) (1988).

116 I.R.C. § 108(b) (1988). Alternatively, a corporation could choose to preserve its net operating losses and other tax attributes by electing instead to reduce the basis in its depreciable assets and certain of its other property. See I.R.C. § 108(b)(5) (1988). In deciding whether to make this election, a corporation would need to take into account § 1017(b)(2), which limits the basis reduction under the ordering rules to the outstanding liabilities of the corporation following the debt discharge, but does not limit basis reduction where a corporation elects to reduce depreciable assets instead of following the ordering rules. I.R.C. § 1017(b)(2) (1988).

117 See I.R.C. § 108(e)(10) (West Supp. 1992).

118 See, e.g., *Commissioner v. Motor Mart Trust*, 156 F.2d 122, 125-26 (1st Cir. 1946); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir.

ardless of whether the issued stock had a fair market value less than the face amount of the debt discharged.<sup>119</sup> The exception applied, however, only when the value of the stock issued in exchange for the debt was more than "nominal or token."<sup>120</sup> Both the exception to the income-from-discharge-of-indebtedness provision and the codification of the stock-for-debt exception greatly assisted corporations attempting to reorganize in bankruptcy.

In addition, the Bankruptcy Tax Act added a new insolvency reorganization provision to the Code. The type G reorganization<sup>121</sup> authorized by the provision allowed a corporation in a Title 11 or similar proceeding<sup>122</sup> to reorganize on a tax-free basis without having to meet the stringent requirements applicable to other types of tax-free reorganizations.<sup>123</sup> For example, in enacting the type G reorganization provisions, Congress eliminated the requirement that the reorganization comply with state merger

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1944).

119 JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 168 (Comm. Print 1984).

120 I.R.C. § 108(e)(8) (West Supp. 1992). The "nominal or token" concept was not defined by statute, and practitioners struggled for years to ascertain a reasonable definition of the term. Finally, on December 7, 1990, the Internal Revenue Service issued regulations under § 108 that provided rules for determining whether stock issued in exchange for debt is "nominal or token." See Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568-01 (1990). For a discussion of these "de minimis" rules, see Stefan R. Boshkov, *Selected Federal Income Tax Consequences of Restructuring Debt of Failing Corporations After the Revenue Reconciliation Act of 1990*, 69 TAXES 214, 221-23 (1991); Seth M. Zachary & Jill Greenwald, *An Analysis of the Stock-For-Debt Exception to Cancellation of Indebtedness Income*, 18 J. CORP. TAX'N 144, 149-54 (1991).

It should be noted that the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 101st Cong., 2d Sess. (1990), contained several rules dealing with the discharge-of-indebtedness provisions of § 108. For example, the 1990 Act provided that the stock-for-debt exception would no longer apply when "disqualified stock," as defined in the Act, was issued in exchange for debt. For a discussion of the 1990 Act provisions, see Andrew N. Berg, *Corporate Debt Restructurings After the Revenue Reconciliation Act of 1990*, 18 J. CORP. TAX'N 124 (1991); Timothy C. Sherck, *Restructuring Today's Financially Troubled Corporation*, 68 TAXES 881 (1990).

121 The G reorganization is found in I.R.C. § 368(a)(1)(G) (1988), which defines a type G reorganization as:

a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

*Id.*

122 The Act defines a similar proceeding as "a receivership, foreclosure, or similar proceeding in a Federal or State court." I.R.C. § 368(a)(3)(A) (1988).

123 S. REP. NO. 1035, *supra* note 109, at 35, *reprinted* in 1980 U.S.C.A.N. at 7049.

laws, as was required in type A reorganizations.<sup>124</sup> The new provisions also eliminated the requirement that the troubled corporation receive only stock of the acquiring corporation in an asset exchange, as was required in type C reorganizations.<sup>125</sup> Moreover, the judicially-created continuity-of-interest requirement imposed on tax-free reorganizations generally<sup>126</sup> was eased considerably for G reorganizations.<sup>127</sup> Accordingly, under the new G reorganization provisions, either an asset transfer or an exchange of stock and securities conducted in accordance with a reorganization plan approved by a court could constitute a tax-free reorganization.<sup>128</sup>

Congress also provided that the net operating losses and other tax attributes of a financially troubled corporation would carry over to the acquiring corporation in a G reorganization pursuant to section 381 of the Code.<sup>129</sup> Furthermore, it added the G reorganization to the list of tax-free reorganizations subject to the limitations imposed by section 382(b).<sup>130</sup>

Although the most significant contribution of the Bankruptcy Tax Act of 1980 was arguably the creation of the G reorganization provisions, it also contained an amendment to section 382(b) that was designed to protect a financially troubled corporation's net operating losses in a bankruptcy reorganization. In theory, adding G reorganizations to the list of tax-free reorganizations governed by section 382(b) ensured that shareholders need only retain twenty percent of the loss corporation's stock in order to preserve its net operating losses after bankruptcy.<sup>131</sup> In practice, however,

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124 *Id.*

125 *Id.*

126 See *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). For an outstanding discussion of the evolution of the continuity-of-interest doctrine, see BITTKER & EUSTICE, *supra* note 39, at 14-17 to 14-31.

127 S. REP. NO. 1035, *supra* note 109, at 36, *reprinted in* 1980 U.S.C.C.A.N. at 7050; see also BITTKER & EUSTICE, *supra* note 39, at 14-102 to 14-103. For a detailed discussion of the application of the continuity-of-interest rules to G reorganizations, see Paul H. Asofsky & William Tatlock, *Reorganizations, Procedures and Corporate Taxes Greatly Affected by Bankruptcy Tax Act*, 54 J. TAX'N 170, 171 (1981).

128 BITTKER & EUSTICE, *supra* note 39, at 14-103.

129 The Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 4(g), 94 Stat. 3389, 3404 (codified as amended in scattered sections of 26 U.S.C.), amended section 381(a)(2) to include G reorganizations in its list of tax-free asset reorganizations. See *supra* note 75 and accompanying text.

130 See *supra* note 75 and accompanying text.

131 I.R.C. § 382(b) (1954) (amended 1976, 1978, 1984, and 1986); see also *supra* notes

the shareholders of a corporation in a Chapter 11 proceeding often retained little, if any, of the reorganized corporation's stock, thereby decreasing the availability of the loss corporation's net operating losses following insolvency reorganization. Congress, apparently considering the realities of practice and recognizing that a loss corporation's creditors were the true owners of a financially troubled corporation,<sup>132</sup> amended section 382(b) to include a provision that treated creditors as shareholders for purposes of the twenty percent continuity-of-interest requirement of section 382(b) in a Title 11 or similar proceeding.<sup>133</sup> That amendment provided as follows:

(7) SPECIAL RULE FOR REORGANIZATIONS IN TITLE 11 OR SIMILAR CASES.—For purposes of this subsection, a creditor who receives stock in a reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) shall be treated as a stockholder immediately before the reorganization.<sup>134</sup>

Thus, a loss corporation could emerge from bankruptcy with all of its net operating losses intact if its creditors and shareholders together received at least twenty percent of the reorganized corporation's stock in the bankruptcy proceeding. By providing a loss corporation with a means by which to protect its net operating losses following an insolvency reorganization, Congress took the first step toward ensuring the success of the newly enacted Chapter 11 bankruptcy proceeding.<sup>135</sup> Unfortunately, just six

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87-89 and accompanying text.

132 The legislative history of the Bankruptcy Tax Act of 1980 recognizes that creditors are the true owners of a financially troubled corporation. The Senate Committee Report states that "the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for 'continuity' purposes." S. REP. NO. 1035, *supra* note 109, at 36-37, *reprinted in* 1980 U.S.C.C.A.N. at 7051. The Senate Report further cites the case of *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), which stands for the proposition that creditors' interests in a loss corporation are proprietary interests for purposes of satisfying the continuity-of-interest doctrine. S. REP. NO. 1035, *supra* note 109, at 33 n.1, *reprinted in* 1980 U.S.C.C.A.N. at 7048.

133 I.R.C. § 382(b)(7) (1980) (repealed 1986).

134 *Id.*

135 Congress took another step in the same direction when it amended § 382(b) again in 1981 to provide that depositors in financially troubled thrift institutions be treated as shareholders for purposes of applying the 20% continuity-of-interest test. *See* The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 242, 95 Stat. 172, 255 (1981); I.R.C. § 382(b)(7)(B)(i) (1981) (repealed 1986). A thrift institution included savings and loan associations as well as savings banks. *See* JOINT COMM. ON TAX'N, 99TH CONG., 1ST

years later, Congress reversed that trend when it enacted the Tax Reform Act of 1986.

### III. LIMITATIONS ON NET OPERATING LOSS CARRYOVERS IMPOSED BY THE 1986 ACT

Shortly after section 382 was amended in 1976, it became apparent that the 1976 version of the statute suffered from many of the same defects as its predecessor.<sup>136</sup> Due to widespread criticism of the provision, the American Law Institute ("ALI") began to study the treatment of net operating losses generally and to analyze whether wholesale revision of section 382 was appropriate.<sup>137</sup> ALI released its findings in 1982 as part of its comprehensive Federal Income Tax Project on Subchapter C.<sup>138</sup> The ALI study proposed an entirely new limitation on the free transferability of net operating losses. Under the ALI proposal, net operating losses would survive an acquisition transaction completely intact; however, the amount of post-acquisition earnings that could be offset by those loss carryovers would be limited to a certain prescribed rate of return, based on the value of the loss corporation immediately before the acquisition.<sup>139</sup> The ALI proposal was based upon a policy of tax neutrality.<sup>140</sup> The proposal's underly-

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SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 293 (Comm. Print 1987) [hereinafter BLUE BOOK].

136 The 1976 version of § 382, like the 1954 version, was uncertain in application, largely because § 269 continued to overlap in some situations with the revised § 382 proposals. See ALI SUBCHAPTER C PROJECT, *supra* note 55, at 204-05. Additionally, the 1976 Act version was extraordinarily complex. *Id.* Finally, according to the ALI report, the central defect inherent in either version was that it:

is too harsh when it disallows any part of a loss carryover that is only a minor incident in an acquisition transaction; at the same time it is too lenient, assuming we are to have any limitations at all, when it allows any fraction of a loss carryover in the absence of any other elements of value.

*Id.* at 201; see also SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 68.

137 See ALI SUBCHAPTER C PROJECT, *supra* note 55, at 200-01.

138 *Id.* at 198-301.

139 *Id.* at 225.

140 *Id.* at 240. According to the ALI study, the purpose of its net operating loss proposal is

to make the tax law more nearly neutral with respect to combination and acquisition transactions involving loss corporations by eliminating gross biases for or against such transactions. It is inconsistent with this purpose either to disallow loss carryovers entirely or to allow them without limitation, and the proposal therefore seeks to steer a middle course.

*Id.*

ing premise was that, following an acquisition transaction, an acquiring corporation should be able to use the acquired corporation's net operating loss carryovers only to the extent that the acquired corporation could have generated income to use them in the absence of such a change in control.<sup>141</sup> As one commentator aptly explained, "Under this approach, a buyer would not pay additional amounts in order to get the benefit of the carryovers and their impact on corporation acquisitions would be neutralized."<sup>142</sup>

At the same time that the ALI project was being conducted, the Staff of the Senate Finance Committee was undertaking another comprehensive Subchapter C study.<sup>143</sup> Issued in September, 1983, the preliminary study contained a proposal for limiting the use of net operating losses following a change in the ownership of a loss corporation which was substantially similar to the ALI proposal. Under the Senate Finance Committee Staff proposal, the use of the net operating losses of a loss corporation following a change in its ownership would be limited in annual amount. The amount would be determined by the losses that the corporation could have used in the absence of a change in ownership had the corporation started to earn income at an assumed rate of return on the assets that it owned at the time that the change in ownership occurred.<sup>144</sup> The Senate Finance Committee Staff argued that its proposal would preserve the averaging function of net operating loss carryovers and would achieve economic neutrality by allowing a buyer to enjoy only those tax benefits that the seller could have enjoyed in the absence of an acquisition. The proposal, the Committee maintained, would also prevent the appearance of trafficking in net operating losses by allowing the use of carry-

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141 BITTKER & EUSTICE, *supra* note 39, at 16-60.

142 Faber, *supra* note 28, at 2-19.

143 STAFF OF SENATE FIN. COMM., 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983) [hereinafter SENATE FIN. COMM. STAFF PRELIMINARY REPORT].

144 *Id.* at 68. According to the proposal, such a rule would prevent new owners from injecting capital into the loss corporation so that the owners could use the net operating losses more quickly than if no change in ownership and capital infusion had occurred. *Id.*

It should be noted that both the ALI proposal and the Senate Finance Committee Staff Preliminary Report contain separate rules for taxable acquisitions and tax-free mergers. The proposals outlined herein illustrate the taxable "purchase" rules of both reports; the "merger" rules were dropped in the final version of § 382, purportedly because they were too complex. See ALI SUBCHAPTER C PROJECT, *supra* note 55, at 237-39; SENATE FIN. COMM. STAFF PRELIMINARY REPORT, *supra* note 143, at 68-74.

overs "only to the extent that they are incidental to the acquired business."<sup>145</sup>

The final report of the Senate Finance Committee Staff was released in 1985 and followed the basic outline of both the ALI proposal and the Staff's Preliminary Report. The proposal, purportedly based solely on the policy of tax neutrality, proposed a single purchase rule whereby any greater-than-fifty-percent change in the stock ownership of a loss corporation would result in a limitation on the use of the corporation's net operating losses thereafter.<sup>146</sup> The limitation was applied on an annual basis and was equal to the value of the loss corporation immediately before the change in ownership, multiplied by an "absorption" rate, which was deemed to be the federal long-term tax-exempt rate.<sup>147</sup> Finally, the report proposed that net operating loss carryovers that were limited by the newly proposed section 382 provisions would not also be subject to disallowance under section 269.<sup>148</sup>

The structure of the final version of section 382, contained in the Tax Reform Act of 1986,<sup>149</sup> was substantially similar to the final proposal of the Senate Finance Committee Staff.<sup>150</sup> It differed from the Committee proposal, however, in many important respects.

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145 SENATE FIN. COMM. STAFF PRELIMINARY REPORT, *supra* note 143, at 99-101.

146 SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 70.

147 *Id.* at 70-71. The absorption rate essentially measured the rate at which a corporation could use its net operating losses to offset taxable income. *Id.* at 71. The Senate Finance Committee Staff Final Report quoted numerous statistics aimed at determining a proper absorption rate for a loss corporation. It concluded that the federal long-term tax-exempt rate found in § 1274(d) of the Code represented a realistic, albeit slightly generous, rate of return for such a corporation. *Id.* at 71-72; see I.R.C. § 1274(d) (1988).

148 SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 56, 250.

149 Pub. L. No. 99-514, 100 Stat. 2085 (1986).

150 BLUE BOOK, *supra* note 135, at 294. The Joint Committee's explanation states that "[t]he Act draws heavily on the recommendations regarding limitations on NOL carryforwards that were made by the Finance Committee Staff as part of its comprehensive final report regarding reform of subchapter C of the Internal Revenue Code." *Id.*



A. *Statutory Framework of the New  
Section 382 Limitations*<sup>151</sup>

In the Tax Reform Act of 1986,<sup>152</sup> Congress adopted a "limitation on earnings" approach for restricting the use of a corporation's net operating losses following a substantial change in the ownership of its stock.<sup>153</sup> Under new section 382 of the Code,<sup>154</sup> restrictions on the use of a corporation's net operating losses are triggered by an "ownership change."<sup>155</sup> An ownership change occurs if the aggregate stockholdings of all five percent shareholders<sup>156</sup> of the loss corporation increase by more than fifty percentage points over the lowest percentage held by such shareholders during a three-year testing period.<sup>157</sup> Each percentage point increase is based not on the number of outstanding shares of the loss corporation, but rather on the total value of the

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151 The discussion of new § 382 does not attempt to cover all of the myriad technical details of that provision. Several articles, however, provide detailed overviews of the new § 382 provisions. See, e.g., Faber, *supra* note 28, at 2-20 to 2-51; Golub, *supra* note 102, at 2-17 to 2-30. Additionally, numerous articles, cited in the footnotes that follow, address the various aspects of new § 382. One commentator best described the enormous complexity of the new § 382 provisions when he wrote that "[t]he rules determining when an ownership change occurs alone are staggering in their intricacy, constituting a labyrinthine morass of hypertechnical regulations that are difficult to comprehend and virtually impossible to apply to real-life situations." Jerred G. Blanchard, Jr., *The Single Entity Theory of the Consolidated Section 382 Regulations: A Study in Complexity*, 69 TAXES 915, 917 n.10 (1991).

152 Pub. L. No. 99-514, 100 Stat. 2085 (1986).

153 See BLUE BOOK, *supra* note 135, at 295. "This 'limitation on earnings' approach is intended to permit the survival of NOL carryforwards after an acquisition, while limiting the ability to utilize the carryforwards against unrelated income." *Id.*

154 The term "Code" hereinafter refers to the Internal Revenue Code of 1986, as amended.

155 I.R.C. § 382(b), (d) (1988).

156 The term "five percent shareholders" is defined *infra* notes 163-66 and accompanying text.

157 I.R.C. § 382(g)(1) (1988). Determining whether an ownership change has occurred can be a complex matter. For example, an ownership change can occur as a result of either (1) an owner shift involving a five percent shareholder; or (2) an equity structure shift. *Id.* A transaction involving an owner shift generally will be a stock acquisition either from a five percent shareholder or by an entity that becomes a five percent shareholder as a result of the purchase. An owner shift can be either a taxable or a tax-free transaction. See BITTKER & EUSTICE, *supra* note 39, at 16-71. An equity structure shift encompasses some type of reorganization under § 368 of the Code. A single transaction, such as a recapitalization, can constitute both an owner shift and an equity structure shift. *Id.* Because § 382 affords the same treatment to both types of ownership changes, some commentators believe that these dual definitions are unnecessary in practice. *Id.*

loss corporation's stock.<sup>158</sup> For example, if creditors of the loss corporation, who previously had owned none of its stock, acquired voting preferred stock of the corporation representing forty percent of the total value of the loss corporation's outstanding stock, and voting common stock representing eleven percent of the total value of its stock, an ownership change would have been triggered. This is so even though the creditors own less than fifty percent of each class of stock because they would own more than fifty percent of the total value of the loss corporation's outstanding stock compared with the amount (zero) that they had previously owned.<sup>159</sup>

For purposes of determining whether an ownership change has occurred, transfers involving non-voting, "pure" preferred stock are disregarded.<sup>160</sup> Regulations promulgated under section 382 prescribe complex rules for treating warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock.<sup>161</sup> In addition, special rules are prescribed for attributing stock owned by a corporation ratably to its shareholders and stock owned by a partnership ratably to its partners.<sup>162</sup>

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158 I.R.C. § 382(k)(6)(C) (1988).

159 This example assumes that the creditors' acquisitions of the voting preferred stock and the voting common stock occur within a three-year period.

160 I.R.C. § 382(k)(6)(A) (1988). So-called "pure" preferred stock is stock that:

(1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights that do not exceed the stock's issue price upon issuance (except for a reasonable redemption premium), and (4) is not convertible to any other class of stock.

BLUE BOOK, *supra* note 135, at 300-01; see also I.R.C. § 1504(a)(4) (1988).

The regulations promulgated under § 382 indicate that, although pure preferred stock is not considered "stock" for determining whether an ownership change has taken place, such stock is nevertheless included for purposes of determining the value of the loss corporation pursuant to § 382(e) of the Code. See Temp. Treas. Reg. § 1.382-2T(f)(18)(i). (as amended in 1992); see also *infra* note 169 and accompanying text. Moreover, the regulations contain rules whereby interests that are not treated as stock, such as pure preferred stock, may nevertheless be treated as constituting stock for purposes of the § 382 limitations. See Temp. Treas. Reg. § 1.382-2T(f)(18)(iii) (as amended in 1992); see also Stuart J. Goldring & Andrew D. Feiner, *Section 382 Ownership Change: The Fundamentals*, 66 TAXES 427, 437-45 (1988); Mark J. Silverman & Kevin M. Keyes, *An Analysis of the New Ownership Regs. Under Section 382: Part I*, 68 J. TAX'N 68, 71-76 (1988).

161 Temp. Treas. Reg. § 1.382-2T(h)(4) (as amended in 1992). For two excellent articles dealing with the treatment of options under § 382, see Timothy C. Sherck, *Treatment of Options in Applying Stock Ownership Tests in the Corporate World*, 66 TAXES 935 (1988); Stuart J. Goldring & Andrew D. Feiner, *Section 382 Ownership Change: Option Attribution*, 66 TAXES 803 (1988).

162 Temp. Treas. Reg. § 1.382-2T(h)(2) (as amended in 1992).

A key determination that must be made in ascertaining whether an ownership change has occurred is identifying the five percent shareholders of a loss corporation. As the term might suggest, the definition of a five percent shareholder encompasses any individual who owns five percent or more of the value of the loss corporation's stock at any time during the three-year testing period.<sup>163</sup> Additionally, all shareholders of the loss corporation owning less than five percent of its stock are aggregated together and deemed to constitute a single five percent shareholder.<sup>164</sup> The regulations set forth a special rule whereby transfers of the stock of a loss corporation between non-five percent shareholders, including transfers between shareholders who are aggregated together and treated as one five percent shareholder of the loss corporation, are disregarded in determining whether an ownership change is triggered.<sup>165</sup> Thus, even if a significant portion of the stock of a widely held corporation changes hands over the three-year testing period, it generally will not trigger an ownership change. Finally, in order to evaluate whether an ownership change has occurred, all transactions involving five percent shareholders during

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163 Temp. Treas. Reg. § 1.382-2T(g)(1)(i) (as amended in 1992). Because the term "five percent shareholder" encompasses any individual who owns the requisite five percent in value of the loss corporation's stock at any time during the three-year testing period, shareholders owning at least five percent of such stock who dispose of their stock during the testing period are considered five percent shareholders, *id.*, as are those who purchase or increase their stockholdings to five percent or more of the loss corporation's stock during the testing period. Temp. Treas. Reg. § 1.382-2T(g)(1)(iv) (as amended in 1992).

In determining stock ownership percentages, the attribution rules of § 318 of the Code apply in modified form. I.R.C. § 382(l)(3)(A) (1988). Moreover, an individual who holds an indirect ownership interest of five percent or more of the stock of a loss corporation by virtue of owning stock of a corporate shareholder of the loss corporation which is attributed to such individual will also be deemed a five percent shareholder. Temp. Treas. Reg. § 1.382-2T(g)(1)(i)(B) (as amended in 1992).

164 I.R.C. § 382(g)(4)(A) (1988); Temp. Treas. Reg. § 1.382-2T(j) (as amended in 1992); BLUE BOOK, *supra* note 135, at 301. The regulations under § 382 provide extraordinarily complex rules for identifying five percent shareholders of a loss corporation, including special rules for aggregating less-than-five percent shareholders into one such shareholder, as well as rules segregating groups into separate five percent shareholders. These rules have been the focus of many excellent articles. See, e.g., William M. Davidow, Jr., *Limitations Imposed by the Tax Reform Act of 1986 on a Corporation's Use of Net Operating Loss Carryovers After an Ownership Change*, 17 BALTIMORE L. REV. 331, 340-49 (1988); Andrew D. Feiner & Stuart J. Goldring, *Section 382 Ownership Change: Identification of 5 Percent Shareholders*, 66 TAXES 619 (1988); Mark J. Silverman & Kevin M. Keyes, *An Analysis of the New Ownership Regs. Under Section 382: Part III*, 68 J. TAX'N 300 (1988).

165 Temp. Treas. Reg. § 1.382-2T(e)(1)(ii) (as amended in 1992).

the three-year testing period are considered, even if the transactions are unrelated.<sup>166</sup>

If an ownership change occurs, section 382 limits the amount of income that may be offset each year by net operating losses incurred prior to the ownership change (the "general limitation").<sup>167</sup> Under the general limitation, the amount of income that can be sheltered each year is equal to the fair market value of the loss corporation immediately prior to the ownership change, multiplied by the federal long-term tax-exempt rate in effect at the time the ownership change occurs.<sup>168</sup> For purposes of the general limitation, the value of the loss corporation is deemed to be equal to the fair market value of its stock, including the value of any "pure" preferred stock that is not treated as stock for purposes of determining whether an ownership change has occurred.<sup>169</sup> The value of the loss corporation is reduced, however, by capital contributions made within the two-year period ending on the date of the ownership change, in order that the loss corporation's shareholders cannot artificially inflate the value of the loss corporation in an effort to increase the general limitation following the ownership change.<sup>170</sup> The general limitation reflects the theory that the purchaser of a loss corporation's net operating loss carryovers should not be entitled to utilize them at

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166 BLUE BOOK, *supra* note 135, at 314.

167 This limitation will be referred to herein as the "general limitation" so as to distinguish it from the special limitations applicable to a corporation's net operating losses in bankruptcy. See *infra* notes 172-94 and accompanying text. In addition to limiting the use of net operating losses incurred prior to the ownership change, § 382 also limits the use of built-in losses at the time the ownership change occurs in certain circumstances. See I.R.C. § 382(h) (1988 & Supp. I 1989); see also Davidow, *supra* note 164, at 354-56.

168 I.R.C. § 382(a), (b)(1) (1988). Section 382 also provides that, with certain limited exceptions, if the new loss corporation fails to carry on the business enterprise of the old loss corporation for two years following the ownership change, the general limitation thereafter will be zero. I.R.C. § 382(c)(1) (1988). In other words, if the continuity-of-business-enterprise requirement (initially established under § 368 of the Code) is not met after an ownership change, none of the loss corporation's net operating loss carryovers can be used. For a discussion of the continuity-of-business-enterprise test, see Rizzi, *supra* note 99, at 127-28.

169 I.R.C. § 382(e)(1) (1988). The long-term tax-exempt rate is published monthly by the Treasury Department. See, e.g., Rev. Rul. 92-23, 1992-14 I.R.B. 6-7. Whether the long-term tax-exempt rate accomplishes the congressional objective of achieving neutrality in the transfer of net operating loss carryovers has been the subject of several law review articles. See, e.g., Simmons, *supra* note 25, at 1069-85.

170 I.R.C. § 382(l)(1) (1988). This rule is often referred to as the "anti-stuffing" rule.

a faster rate than the loss corporation could have generated income to use them in the absence of an ownership change.<sup>171</sup>

*B. Special Statutory Provisions Affecting Corporations  
in Title 11 Proceedings*

Because the value of the stock of a loss corporation in bankruptcy will normally be negligible immediately prior to any ownership change resulting from its reorganization plan, the general limitation will normally eliminate any significant benefit from the net operating losses of such a corporation.<sup>172</sup> For this reason, there are two special provisions that may enable a loss corporation in a Title 11 case to use a portion of its net operating losses following an ownership change. As described more fully below, the first of these special provisions would render the general limitation inapplicable in certain circumstances, but would impose other limitations on a loss corporation's use of its net operating loss carryovers following an ownership change in bankruptcy.<sup>173</sup> This approach will be referred to hereinafter as the "bankruptcy alternative." The second of the two special provisions would apply the general limitation, but would permit the value of the loss corporation to be determined immediately following the ownership change, rather than just prior to the ownership change.<sup>174</sup> This provision will be referred to hereinafter as the "special insolvency limitation."

1. The Bankruptcy Alternative

Recognizing that the creditors of a loss corporation are, in reality, its true owners and that they have borne the economic burden of those losses reflected in the corporation's net operating loss carryovers, Congress provided limited relief from the application of the general limitation in the form of the bankruptcy alternative.<sup>175</sup> The bankruptcy alternative, rather than the general

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171 BLUE BOOK, *supra* note 135, at 296.

172 *Id.* at 299. For example, if a loss corporation had assets of \$200 million and liabilities of \$350 million immediately before undergoing an ownership change in a Title 11 proceeding, the value of the loss corporation, for purposes of calculating the general limitation, would be zero. Thus, none of its net operating losses could be used to offset its income following the ownership change under the general limitation.

173 See *infra* notes 175-90 and accompanying text.

174 See *infra* notes 191-94 and accompanying text.

175 BLUE BOOK, *supra* note 135, at 299. The Joint Committee Report provides that, in the case of an insolvent corporation, "the loss corporation's creditors are the true owners

limitation, applies<sup>176</sup> to any ownership change experienced by a loss corporation that meets two requirements. First, the loss corporation must be under the jurisdiction of a court in a Title 11 or similar case<sup>177</sup> immediately before the ownership change.<sup>178</sup> Thus, a corporation undergoing an ownership change in a Chapter 11 bankruptcy proceeding will satisfy the first requirement for application of the bankruptcy alternative.

Second, those persons who were the shareholders and/or creditors of the loss corporation immediately before the ownership change must own, immediately after the ownership change and as a result of the ownership of their prior interests, stock of the loss corporation representing at least fifty percent of the total voting power and fifty percent of the total value of the loss corporation's outstanding stock.<sup>179</sup> The bankruptcy alternative's second requirement can also be met if the historic creditors and/or shareholders of the loss corporation own the same percentage of stock of a parent corporation, rather than of the subsidiary loss corporation, and if the parent is also involved in a bankruptcy proceeding.<sup>180</sup>

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of the corporation, although it may be impossible to identify the point in time when ownership shifted from the corporation's shareholders." *Id.* The Joint Committee Report cites *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), which has long stood for the proposition that creditors of an insolvent corporation are its true owners. *Alabama Asphaltic* provides that:

[w]hen the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders.

*Id.* at 184 (citations omitted).

176 If its requirements are met, application of the bankruptcy alternative is automatic, unless the debtor corporation makes an affirmative election not to have the provisions apply. For a discussion of this election, see *infra* notes 190-92 and accompanying text.

177 A "Title 11 or similar case" includes proceedings commenced under any chapter of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 (1988 & Supp. II 1990), as well as a receivership, a foreclosure, or a similar proceeding commenced in either federal or state court. I.R.C. § 368(a)(3)(A) (1988).

178 I.R.C. § 382(d)(5)(A)(i) (1988). The legislative history additionally provides that the bankruptcy alternative will only apply if the transaction giving rise to the ownership change either (1) is ordered by the court; or (2) takes place pursuant to a plan that is approved by such court. BLUE BOOK, *supra* note 135, at 321.

179 I.R.C. § 382(d)(5)(A)(ii) (1988). In determining whether shareholders and creditors together own the requisite 50% of the loss corporation's stock, so-called "pure" preferred stock is not counted in the calculation. See I.R.C. § 1504(a)(2), (4) (1988). For a definition of "pure" preferred stock, see *supra* note 160 and accompanying text.

180 I.R.C. § 382(d)(5)(A)(ii) (1988).

Responding to concerns that an outside investor might purchase creditors' claims either immediately prior to the bankruptcy proceeding or during the proceeding, and then exchange such claims for stock without triggering the general limitation,<sup>181</sup> Congress fashioned a special rule whereby only stock received by certain creditors would be taken into account in satisfying the fifty percent ownership test. The rule provided that in order for stock received by a creditor in exchange for indebtedness to be taken into account, the creditor must have held the indebtedness for at least eighteen months before the filing of the bankruptcy proceeding, or the indebtedness must have arisen in the ordinary course of the loss corporation's trade or business.<sup>182</sup> These historic creditors are often referred to as "old and cold" creditors.

If the bankruptcy alternative applies, the general limitation is inapplicable. Instead, the net operating loss carryovers of the loss corporation are reduced by the sum of (1) the interest paid or accrued by the loss corporation during the taxable year in which the ownership change occurs (ending on the date of the ownership change) and in the three preceding taxable years on that portion of the indebtedness converted into stock under the reorganization plan (the "interest reduction");<sup>183</sup> and (2) one-half

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181 The Joint Committee Report provided the following hypothetical as an example of potential abusive transactions that could occur if the bankruptcy alternative were generally available:

For example, if there were a general stock-for-debt exception, an acquiring corporation could purchase a loss corporation's debt immediately before or during a bankruptcy proceeding, exchange the debt for stock without triggering the special limitations, and then use the loss corporation's NOL carryforwards immediately and without limitation.

BLUE BOOK, *supra* note 135, at 299.

182 I.R.C. § 382(d)(5)(E) (1988). Indebtedness arising in the ordinary course of the loss corporation's trade or business must be held by the creditor who "at all times held the beneficial interest in such indebtedness." *Id.* Thus, ordinary course indebtedness cannot be sold by the original creditor if the loss corporation is to count the stock received in exchange for it toward the 50% requirement. According to the legislative history, indebtedness will be treated as ordinary course only if the loss corporation incurs the indebtedness "in connection with the normal, usual, or customary conduct of its business." BLUE BOOK, *supra* note 135, at 321. In many contexts it is very difficult to determine whether indebtedness meets this ordinary course standard. See *infra* notes 221-22 and accompanying text.

183 I.R.C. § 382(d)(5)(B) (1988). The theory behind this net operating loss reduction is that the debt that was converted into stock was in essence an equity interest during such three-year period, and payments made to equity holders are nondeductible. See SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 249-50; see also BITTKER & EUSTICE, *supra* note 39, at 16-88.

of the amount of debt discharged in the bankruptcy reorganization that would not otherwise reduce the net operating loss carryovers of the loss corporation because of the stock-for-debt exception.<sup>184</sup>

To illustrate the application of these rules, assume that a debtor corporation has \$100 of net operating loss carryovers and debt of \$90, of which \$10 is accrued interest. If the corporation issues only stock with a \$50 value in exchange for its debt, its net operating losses would be reduced under the bankruptcy alternative to \$75. This number is determined by reducing the net operating losses of \$100 first by the \$10 of accrued interest, to \$90. The losses are then further reduced by \$15, representing one-half of debt discharged for stock, excluding the interest reduction already taken into account (\$90 of debt less \$50 stock value received less \$10 interest reduction =  $\$30 \times .5 = \$15$ ), leaving net operating loss carryovers of \$75.

As originally enacted, section 382(l)(5) required a double reduction of a loss corporation's net operating loss carryovers for accrued interest that was included as part of the debt canceled in exchange for stock. The Technical and Miscellaneous Revenue Act of 1988,<sup>185</sup> however, amended section 382 so that such accrued interest was not counted twice.<sup>186</sup> Under the bankruptcy alternative, a loss corporation need not meet the two-year business continuity requirement of section 382(c).<sup>187</sup>

A major disadvantage of the bankruptcy alternative is that, if a second ownership change occurs within two years after the first

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184 I.R.C. § 382(l)(5)(C) (1988); *see also* I.R.C. § 108(e)(10)(B) (West Supp. 1992). As part of the Revenue Act of 1987, H.R. 3545, 100th Cong., 1st Sess. § 10136(b) (1987), the House attempted to reduce a loss corporation's net operating loss carryovers by 100%, rather than 50%, of discharged debt for which the stock-for-debt exception was applicable. The House of Representative's amendment was dropped in the final version of the legislation. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987). This debt discharge provision appears to have no policy justification, except as a source of raising revenue.

185 Pub. L. No. 100-647, 102 Stat. 3342 (1988) [hereinafter TAMRA].

186 TAMRA § 1006(d)(18), 102 Stat. at 3398; *see* I.R.C. § 382(l)(5)(C)(ii) (1988). In the example above, if the corporation had issued stock with a \$50 value in exchange for its debt prior to the amendments made by TAMRA, its net operating losses would have been reduced under the bankruptcy alternative to \$70 rather than \$75. The calculation would be made as follows: \$100 of net operating losses less (1) \$10 interest reduction, less (2) one-half times \$40 of debt discharged (\$90 of debt minus \$50 of stock equals \$40), or \$20.

187 *See* 57 Fed. Reg. 343 (1992) (to be codified at Treas. Reg. § 1.382-3(m)). *But see infra* notes 209-13 and accompanying text.



ownership change, the net operating loss carryovers of the loss corporation are completely eliminated for periods subsequent to the second ownership change.<sup>188</sup> Moreover, the general limitation, rather than the bankruptcy alternative, becomes applicable retroactively to the period between the ownership changes.<sup>189</sup>

A loss corporation involved in a Title 11 proceeding may elect not to have the bankruptcy alternative apply.<sup>190</sup> If such an election is made, either the general limitation will apply or, if the requirements below are satisfied, the "special insolvency limitation" will apply.

## 2. The Special Insolvency Limitation

If the loss corporation elects to forego application of the bankruptcy alternative, or if the bankruptcy alternative does not apply to an exchange of stock for debt in a Title 11 proceeding,<sup>191</sup> the general limitation will apply, but with the modifications provided by the special insolvency limitation.<sup>192</sup> Under the special insolvency limitation,<sup>193</sup> the value of the loss corporation, for purposes of calculating the general limitation, is determined immediately *after* the ownership change, rather than immediately

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188 I.R.C. § 382(d)(5)(D) (1988). The Senate Finance Committee Staff best explained the reason for this provision in its Final Report: "Because the value of the corporation at the time of the Title 11 change was presumably zero, and any capital contributions during the ensuing two years are disregarded, this rule explicitly provides that the section 382 limitation at the time of the second change would be zero." SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 56.

189 *Id.*; see also Robert A. Jacobs, *The Chapter 11 Corporate Tax Survival Kit or How to Succeed As Guardian Ad Litem of a Corporate Debtor's NOLs*, 42 TAX LAW. 3, 20 n.78 (1988).

190 I.R.C. § 382(d)(5)(H) (1988).

191 The bankruptcy alternative might not apply, for example, if creditors who do not qualify as "old and cold" creditors receive more than 50% of the loss corporation's stock in the bankruptcy reorganization.

192 The special insolvency limitation provides as follows:

(6) SPECIAL RULE FOR INSOLVENCY TRANSACTIONS. — If paragraph (5) does not apply to any reorganization described in subparagraph (G) of section 368(a)(1) or any exchange of debt for stock in a title 11 or similar case (as defined in section 368(a)(3)(A)), the value under subsection (e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

I.R.C. § 382(d)(6) (1988).

193 Although this Article refers to § 382(d)(6) as the "special insolvency limitation," and that section is entitled "Special Rule For Insolvency Transactions," these references are somewhat misleading. It is not a prerequisite that a corporation be insolvent in order to invoke § 382(d)(6) of the Code. Rather, the corporation must be involved in a Title 11 proceeding, and either (1) be engaged in a G reorganization; or (2) exchange debt for stock in that Title 11 proceeding. *Id.*

before the ownership change. Thus, this calculation reflects the increase in the value of the loss corporation's stock attributable to any surrender or cancellation of creditors' claims in exchange for stock.<sup>194</sup> For example, assume that a loss corporation in a Chapter 11 bankruptcy proceeding has assets of \$200 and liabilities of \$350 immediately before undergoing an ownership change as part of its reorganization plan. For purposes of applying the general limitation, the value of the loss corporation would be zero immediately prior to the ownership change. If, however, the loss corporation's creditors agree to cancel all of their claims in exchange for one hundred percent of the loss corporation's stock as part of the reorganization plan, the value of the loss corporation immediately after the ownership change (and as a result of the cancellation of creditors' claims in exchange for stock) will be \$200, and this value, rather than zero, will be used for calculating the general limitation.

#### IV. A CRITIQUE OF THE BANKRUPTCY ALTERNATIVE AND THE SPECIAL INSOLVENCY LIMITATION AND A PROPOSED SOLUTION

In theory, the intent of Congress in enacting the bankruptcy alternative and the special insolvency limitation was to facilitate the successful reorganization of corporations in Chapter 11 proceedings. In practice, however, the provisions are unsuccessful in implementing these goals. Both the bankruptcy alternative and the special insolvency limitation are fraught with uncertainty. Moreover, the considerations involved in choosing between the two provisions are extraordinarily complex. Oftentimes, both provisions result in a significant reduction in a debtor corporation's net

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194 *Id.*; see also BLUE BOOK, *supra* note 135, at 322. Several commentators have observed that the special insolvency limitation "is an exception to the requirement that the loss corporation's value be reduced for capital contributions received during the two-year period ending on the ownership change date." Brian B. Gibney & Carleen R. Hayes, *Limitations on the Use of Net Operating Loss Carryovers*, 95 COM. L.J. 56, 71 (1990); see also *supra* note 170 and accompanying text.

As originally enacted, the special insolvency limitation would have permitted the loss corporation's value to be increased not only by the cancellation of creditors' claims in the bankruptcy reorganization, but also by an infusion of new capital by an outside investor as part of the bankruptcy reorganization. The provisions of TAMRA clarified that only those increases to the loss corporation's value resulting from the cancellation of creditors' claims would be considered for purposes of the special insolvency limitation. See TAMRA, § 1006(d)(9), 102 Stat. at 3397, formerly the Technical Corrections Bill of 1988, S. 2238, H.R. 4333, 100th Cong., 2d Sess. (1988).

operating losses following bankruptcy reorganization, without any underlying policy justification. Each of these topics is considered separately below. Accordingly, an amendment to section 382 is necessary to achieve the goal of successfully rehabilitating financially troubled corporations in Chapter 11.

*A. The Complex Election Between the  
Two Bankruptcy Provisions*

Any bankruptcy reorganization plan in which the loss corporation's creditors receive more than fifty percent of its stock (a "creditors' plan") will effect an ownership change. If an ownership change occurs, the corporation's net operating loss carryovers will be restricted under either the bankruptcy alternative or the special insolvency limitation, as discussed below.

For purposes of analysis, assume that under a creditors' plan one hundred percent of the loss corporation's stock is received by the creditors in exchange for all of their claims, thereby triggering an ownership change. The exchange qualifies for the bankruptcy alternative because the creditors of the corporation before the reorganization own at least fifty percent of its stock following the reorganization.<sup>195</sup> Alternatively, because the plan involves an exchange of stock for debt in the loss corporation's Title 11 proceeding, it qualifies for the special insolvency limitation if the corporation elects out of the bankruptcy alternative.

The following computations will be used as a framework for discussing the complex election between the bankruptcy alternative and the special insolvency limitation, and will illustrate the effect of the two alternatives on the debtor corporation's net operating losses. The computations are based on the following assumptions: (1) immediately before the ownership change, the corporation has \$300 million of net operating losses, indebtedness of \$350 million (including accrued interest of \$6 million), and net assets of \$200 million (excluding the \$350 million of debt); and (2) interest paid or accrued on debt during the relevant period includes \$54 million paid as well as the \$6 million accrued and included in the \$350 million of debt.

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<sup>195</sup> The creditors must meet the definition of "old and cold" creditors pursuant to I.R.C. § 382(d)(5)(E) (1988).

*Bankruptcy Alternative*  
(in millions)

Net operating losses before ownership change:		\$300
Net operating loss reductions:		
Interest reduction: <sup>196</sup>		\$60
Reduction for debt discharge income:		
Debt discharged for stock:	\$350	
Less: Accrued interest included in debt discharge: <sup>197</sup>	<u>\$6</u>	
	\$344	
Less: Value of stock exchanged for debt:	<u>\$200</u>	
Debt discharge income: <sup>198</sup>	\$144	
One-half thereof: <sup>199</sup>	<u>\$72</u>	
Total reductions:		<u>\$132</u>
Net operating losses after ownership change: <sup>200</sup>		\$168

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196 I.R.C. § 382(d)(5)(B) (1988).

197 I.R.C. § 382(d)(5)(C) (1988).

198 I.R.C. § 61(a)(12) (1988).

199 I.R.C. § 382(d)(5)(C).

200 The \$300 million of net operating losses approximates the operating losses claimed or to be claimed by the loss corporation in its returns. If the Internal Revenue Service reduces these amounts upon audit, the amount available under the bankruptcy alternative after an ownership change would, of course, be less by the amount of the audit reductions.

Now suppose that the creditors received, in exchange for their debt, not only all of the stock of the loss corporation, but also \$100 million of new debt. The effect on the corporation's net operating losses would be as follows:

Net operating losses before change:	\$300
Net operating loss reductions:	
Interest reduction on debt discharged for stock: ( $\$60 \times \$250/\$350$ )	\$43
Reduction for debt discharge income:	
Debt discharged for stock:	\$250
Less: accrued interest included in debt discharge: ( $\$6 \times \$250/\$350$ )	<u>\$4.3</u>
	\$245.7
Less: Value of stock exchanged for debt:	<u>\$100</u>
Debt discharge income:	\$145.7
One-half thereof:	<u>\$72.85</u>
Total reductions:	<u>\$115.85</u>
Net operating losses after ownership change:	\$184.15

Note that on the facts assumed, the available net operating losses increase by \$16.15 million when the amount of debt discharged is reduced by issuing \$100 million of new debt.<sup>201</sup> Accordingly, the bankruptcy alternative provides creditors with the flexibility to obtain debt in addition to stock without adversely affecting the loss corporation's net operating losses, provided that the amount of stock issued in relation to debt is not nominal or token. It is noteworthy that any stock allotted to shareholders or management instead of the corporation's creditors will reduce the value of the stock exchanged for the creditors' debt, thereby increasing the aggregate amount of debt cancellation and resulting in a greater net operating loss reduction.

Now suppose that the loss corporation elects not to have the bankruptcy alternative apply, so that the effect of the ownership change upon utilization of its net operating loss carryovers is determined under the special insolvency limitation.

*Special Insolvency Limitation*  
(in millions)

Value of the loss corporation's stock immediately prior to ownership change (assets of \$200, liabilities of \$350):	\$0
Increase in value of the loss corporation's stock due to cancellation of \$350 of debt in exchange for 100% of stock:	<u>\$200</u>
Long-term tax-exempt rate (assumed):	<u>7.5%</u>
Annual limitation under special insolvency limitation (allowable each year until net operating losses expire or are fully utilized):	
\$200 x .075	\$15

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201 The \$16.15 million consists of the \$17 million of interest reduction attributable to the \$100 million of debt discharged in the first computation, but not in the second computation, minus one-half of the \$1.7 million of interest assumed to be included in the debt discharged in the first computation but not in the second computation.

If it is assumed instead that the debtor corporation issues all of its stock plus \$100 million of new debt in exchange for the \$350 million of old debt held by the creditors, the increase in value of the stock attributable to debt cancellation would be only \$100 million instead of \$200 million as in the above computation. As a result, the annual amount of net operating losses that are available under the special insolvency limitation would be \$7.5 million rather than \$15 million. Of course, the interest on the \$100 million of debt is deductible without limitation as long as the debt is outstanding.

The foregoing scenarios demonstrate that the choice between the bankruptcy alternative and the special insolvency limitation can be extraordinarily difficult and complex. Assuming that a debtor corporation qualifies for both special bankruptcy provisions, a number of factors will bear upon the choice between the bankruptcy alternative and the special insolvency limitation. First, if all of the existing debt is canceled in exchange for all of the loss corporation's stock, the bankruptcy alternative in the foregoing illustration would leave \$168 million of net operating losses available to offset the corporation's taxable income as rapidly as it could generate that income. On the other hand, the special insolvency limitation would produce an annual amount of net operating losses of \$15 million available to offset taxable income. Assuming that all of the available net operating losses could be absorbed by the loss corporation's future before-tax income prior to the expiration of the applicable fifteen-year carryover period, \$225 million (fifteen years times \$15 million per year) of net operating losses could be utilized under the special insolvency limitation. If the loss corporation's anticipated before-tax earnings would substantially exceed \$15 million per year, the bankruptcy alternative would result in faster utilization of the net operating losses. This might prove more valuable to the corporation even if the net operating losses are less in total amount than under the special insolvency limitation. Unfortunately, it is difficult for corporations emerging from Chapter 11 reorganization proceedings to estimate their future earnings with any accuracy. Accordingly, a corporation relying on rosy financial projections might elect the bankruptcy alternative so that it could utilize its net operating losses rapidly; however, should those financial projections not materialize, the corporation might discover that it suffered a reduction in its net operating losses by electing the bankruptcy alternative without any offsetting benefit.

A second factor affecting a debtor corporation's choice between the two bankruptcy provisions is that, under the special insolvency limitation, cancellation of less than all of the loss corporation's debt results in a greater net operating loss reduction than cancellation of all of the debt. On the other hand, under the bankruptcy alternative, a smaller net operating loss reduction may result if some debt is left outstanding rather than if all of the debt is canceled, depending upon the interest reduction attributable to the debt discharged.<sup>202</sup> Accordingly, if, as is often the case, creditors insist on retaining at least a portion of their debt, a loss corporation might be forced to elect the bankruptcy alternative even if countervailing factors indicate that the special insolvency limitation is otherwise warranted. Moreover, attorneys for both the debtor corporation and its creditors must engage in complex calculations to determine the impact of debt retention on the corporation's net operating losses under both alternatives.

Although the first two factors tend to favor the bankruptcy alternative, there are two other factors that favor the special insolvency limitation. Under the bankruptcy alternative, net operating losses are actually reduced by the accrued interest and debt reduction amounts outlined above. Conversely, under the special insolvency limitation, there is no reduction in a corporation's net operating losses, but the ability of net operating losses to offset taxable income is curtailed. For example, the scenarios described above illustrate that net operating losses under the bankruptcy alternative are reduced to \$168 million, while they remain at \$300 million under the special insolvency limitation (but a maximum of \$225 million can be used before they expire). If the Internal Revenue Service successfully challenges the deductions comprising a debtor corporation's net operating losses once it begins to use them to offset taxable income following bankruptcy, the result will be a reduction in the corporation's available net operating losses. Such

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202 Following the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a), 104 Stat. 1388, 1388-1466 (1990), if a corporation issues new debt in exchange for existing debt, adverse tax consequences may result. Under new § 108(e)(11) of the Code, a debt-for-debt exchange may result in income from cancellation of indebtedness to the loss corporation issuing the new debt (or a reduction in its net operating losses assuming that the exchange takes place in a Title 11 proceeding), as well as original issue discount income to the creditor holding the debt. I.R.C. § 108(e)(11) (West Supp. 1992). A discussion of this complex new provision is beyond the scope of this Article. For a detailed discussion of § 108(e)(11) and its impact on debtor corporations in bankruptcy proceedings, see William Hoke, *The Tax Consequences of Restructuring Troubled Corporations' Debt*, FAULKNER & GRAY'S BANKR. L. REV., Fall 1991, at 31.



a reduction will have a far more significant impact on available net operating losses under the bankruptcy alternative than under the special insolvency limitation.

To illustrate, assume that challenges by the Service result in a \$50 million reduction in net operating losses. Under the special insolvency limitation, available net operating losses would be reduced from \$300 million to \$250 million; however, because a maximum of \$225 million could be used during the fifteen-year carryover period to offset taxable income, the Service's successful challenge would not diminish the availability of net operating losses under this limitation. Conversely, under the bankruptcy alternative, net operating losses would be reduced from \$168 million to \$118 million, thereby significantly affecting the availability of these losses. Because it is often impossible to predict whether the Internal Revenue Service will wage such a challenge once the loss corporation begins to utilize its net operating losses, and difficult to gauge whether such a challenge, if made, will prove successful, it is hard to determine what weight this factor should be given when choosing between the bankruptcy alternative and the special insolvency limitation.

The second factor that renders the bankruptcy alternative less attractive is that a corporation's net operating losses under that provision are virtually eliminated if a second ownership change occurs within two years after the bankruptcy reorganization.<sup>203</sup> By contrast, if the special insolvency limitation is elected, a second ownership change would only cause a new limitation to be computed using the general limitation provisions of section 382. Unless the value of the stock had declined in the intervening period, the annual amount of net operating losses available following such a second ownership change would not be affected adversely.<sup>204</sup> To preclude the possibility of a second ownership change under the bankruptcy alternative, most tax practitioners require that at least half of the debtor corporation's stock contain restrictions prohibiting its transfer for a two-year period.<sup>205</sup> Such transfer restrictions significantly reduce the value of the loss corporation's stock and may also prove unacceptable to certain creditors, such

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203 I.R.C. § 382(d)(5)(D) (1988).

204 See Prop. Treas. Reg. § 1.382-3(n)(2), 57 Fed. Reg. 34,736, 34,740 (1992).

205 See Sniderman et al., *supra* note 20, at 201. A private letter ruling permitted stock transfer restrictions to be imposed by an amendment to the corporate charter approved as part of the reorganization plan. See Priv. Ltr. Rul. 89-49-040 (Sept. 11, 1989).

as banks subject to restrictions limiting the time that they can hold common stock of a corporation.<sup>206</sup>

Each of these factors suggests that one of the special bankruptcy provisions is preferable to the other. In combination, they make an informed election between the bankruptcy alternative and the special insolvency limitation almost impossible.

### *B. Uncertainties Inherent in the Special Bankruptcy Provisions*

Not only is the interplay between the bankruptcy alternative and the special insolvency limitation extraordinarily complex, but each individual bankruptcy provision is subject to considerable uncertainty and contains many complexities on its own. Commentators have suggested that the uncertainties in the various bankruptcy tax provisions result from the lack of any predominant underlying policies or principles.<sup>207</sup>

#### **1. The Bankruptcy Alternative**

Because the incidence of Chapter 11 bankruptcy reorganizations has risen dramatically over the past few years, section 382(l)(5) of the Code has recently taken on increasing importance. Over the course of the past year, regulations affecting the bankruptcy alternative have been promulgated on almost a monthly basis.<sup>208</sup> Although these regulations have clarified some open issues, a number of other issues are as yet unresolved.

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206 See, e.g., IOWA CODE, § 524.901 (1991); KAN. STAT. ANN. § 9-1112 (1991); MO. REV. STAT. § 362.170 (Supp. 1991).

207 See Rizzi, *supra* note 20, at 134; see also Robert A. Jacobs, *Report on Suggested Bankruptcy Tax Revenue Rulings*, 50 TAX NOTES 631, 631 (1991) (The author suggests that bankruptcy tax law "is complex, inconsistent, and unpredictable. Its underlying policies are uncertain; its applications erratic. There is no first principle to provide direction.").

208 For example, the Internal Revenue Service promulgated temporary and final regulations on April 9, 1992 dealing with the impact of the option attribution rules on § 382(l)(5). See 57 Fed. Reg. 12,208, 12,210 (1992) (to be codified at Temp. Treas. Reg. § 1.382-2T, -3(e), (o)). On March 30, 1992, the Service issued final regulations defining the concept of an "entity" for purposes of the § 382 general limitation, with a special "entity" definition for creditors in a bankruptcy reorganization. See 57 Fed. Reg. 10,739, 10,740 (1992) (to be codified at Treas. Reg. § 1.382-2(a)(3)(i)). On January 6, 1992, the Service promulgated final regulations relating to the interplay between § 269 and § 382(l)(5). See 57 Fed. Reg. 343, 345 (1992) (to be codified at Treas. Reg. § 1.269-3(d)). Finally, on September 23, 1991, the Service issued proposed regulations under § 382(l)(5) addressing the issue of which creditors will be deemed to be "old and cold" creditors for purposes of the bankruptcy alternative. See Prop. Treas. Reg. § 1.382-3(d), 56 Fed. Reg. 47,921, 47,924 (1991).

For example, commentators have often suggested that one of the benefits of the bankruptcy alternative over the general limitation of section 382, and presumably the special insolvency limitation as well, is that under the bankruptcy alternative, a loss corporation is not required to satisfy the two-year continuity-of-business-enterprise requirement that is imposed for other ownership changes.<sup>209</sup> Recently promulgated regulations under section 269 of the Code, however, draw this so-called advantage into question. The regulations set forth a presumption of tax avoidance:

Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(d)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case.<sup>210</sup>

The regulations indicate that in determining whether the loss corporation is deemed to carry on more than an insignificant amount of an active trade or business, the continuity-of-business-enterprise requirement of section 382(c) should be disregarded.<sup>211</sup> The regulations thus leave a loss corporation in considerable doubt as to how much of its business it must continue to carry on following an ownership change in order to qualify for the bankruptcy alternative.<sup>212</sup> Moreover, a corporation's failure to

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209 See Prop. Treas. Reg. § 1.382-3(c), 55 Fed. Reg. 36,657, 36,659 (1990); Richard E. Halperin, *Planning for Loss Carryovers Under Section 382 When A Corporation is Insolvent*, 71 J. TAX'N 150, 153 (1989). Section 382(c) of the Code contains the business continuity rule, which provides: "[I]f the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the 2-year period beginning on the change date, the section 382 limitation for any post-change year shall be zero." I.R.C. § 382(c)(1) (1988).

210 57 Fed. Reg. 343, 345 (1992) (to be codified at Treas. Reg. § 1.269-3(d)(1)).

211 *Id.*

212 Although the regulation attempts to provide some guidance as to what would qualify as more than an insignificant amount of an active trade or business, it basically indicates that a facts and circumstances determination will be used. *Id.* The regulation states that:

[w]here the corporation continues to utilize a significant amount of its business assets or work force, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease for a period of time in order to address business exigencies.

*Id.* at 346.

Some commentators have suggested that loss corporations can resort to other Code provisions, such as § 368, in attempting to determine what is meant by the phrase "more

meet the nebulous test set forth in the regulations would result in a complete elimination of the debtor corporation's net operating losses under section 269.<sup>213</sup>

Finally, the regulations' active trade or business test is difficult to justify on policy grounds for two reasons. First, it could result in an unprofitable business remaining intact merely for tax purposes when sound business judgment would dictate otherwise. Such a result contravenes the neutrality concept upon which section 382 is arguably based.<sup>214</sup> As several commentators have aptly stated, the presumption of tax avoidance in the section 269 regulations serves to "undermine Congress's intent in providing the bankruptcy exception, which was to aid in the rehabilitation of bankrupt corporations."<sup>215</sup> Second, historic creditors of a loss corporation are to be treated as shareholders for purposes of the bankruptcy alternative. Accordingly, the presumption of tax avoidance in the section 269 regulations runs contrary to the premise upon which the bankruptcy alternative is based by treating creditors differently from shareholders. As one commentator explained,

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than an insignificant amount of an active trade or business." See, e.g., Janet A. Meade & Janice E. McClellan, *Loss Carryovers in Corporate Bankruptcy Reorganizations Under Prop. Reg. § 1.269-3(d)*, 69 TAXES 229, 233 (1991). Those provisions, however, are illustrative in the "continuity-of-business-enterprise" area and thus would not be of much assistance here because the § 269 regulations' business continuity test is purportedly a different, and presumably less burdensome, one.

213 I.R.C. § 269 (1988); see also *supra* notes 68-73 and accompanying text.

214 See SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 70-71. It is interesting to note that under the Finance Committee Staff's Final Report, § 269 would not apply to transactions governed by § 382. *Id.* at 56. Congress obviously ignored the Committee's proposal, stating in the House Conference Report to the 1986 Tax Act that the newly revised provisions of § 382 would not override the continuing application of § 269. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 194 (1986), reprinted in 1986 U.S.C.A.N. 4075, 4282.

The proposed regulations under § 269 also discuss the interplay between that provision and § 1129(d) of the Bankruptcy Code, 11 U.S.C. § 1129(d) (1988). Section 1129(d) provides that a governmental unit can request that a reorganization plan not be confirmed if its principal purpose is the avoidance of taxes. The section also states that the governmental unit bears the burden of proof on the tax avoidance issue. Under 57 Fed. Reg. 343, 346 (1992) (to be codified at Treas. Reg. § 1.269-3(e)), the fact that a governmental unit did not challenge confirmation of the reorganization plan under § 1129(d) of the Bankruptcy Code is not considered when determining whether the principal purpose of an acquisition of a loss corporation is the avoidance of federal income tax. Apparently the reason for this § 269 regulation is that the burden of proof under the Bankruptcy Code provision is on the government, while the burden of proof under § 269 is on the taxpayer. "The presumptive position of the proposed regulation, therefore, is especially strong since a court ruling as to the motive of the transaction is not controlling." Meade & McClellan, *supra* note 212, at 232.

215 Carmen Eggleston, *Financial Statements*, AM. BANKR. INST. NEWSL., Feb. 1992, at 12.

Continuing shareholders are not subject to the tax avoidance rules of Section 269. Also, such owners are not required to continue a losing business to use the tax attributes of the business against the income of a new investment. The explanation in the Proposed Regulations for subjecting ownership changes described in Section 382(d)(5) to special scrutiny and presuming a tax avoidance purpose unless the corporation carries on more than an insignificant amount of business does not explain the significant departure from the prior parallel treatment of such creditors.<sup>216</sup>

A second area of considerable uncertainty under the bankruptcy alternative is how to determine which creditors qualify as historic creditors of the loss corporation. Although the issue has been clarified somewhat by recently promulgated regulations, it remains a difficult one.<sup>217</sup>

Under the newly proposed regulations, a creditor qualifies as an historic creditor under the bankruptcy alternative if the creditor holds "qualified indebtedness." Indebtedness must fall into one of three categories in order to constitute qualified indebtedness: (1) it has been owned by the same beneficial owner for at least eighteen months before the filing of the Title 11 case; (2) it arose in the ordinary course of the loss corporation's trade or business and has been held at all times by the same beneficial owner; or (3) it falls within the regulations' new category of "widely held indebtedness."<sup>218</sup>

The first category of qualified indebtedness, eighteen-month debt, is relatively straightforward. The regulations clarify that an otherwise qualified creditor who undergoes an ownership change generally will not lose its status as a qualified creditor. If, however, the indebtedness represents more than twenty-five percent of such creditor's assets, the ownership change will cause the indebtedness to become disqualified.<sup>219</sup> This rule is intended to prevent an outside investor from purchasing the stock of a creditor in order to circumvent the eighteen-month holding period requirement. Unfortunately, the rule as stated has much broader application and could disqualify creditors' indebtedness under circumstances in which no such motive is present.<sup>220</sup>

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216 Richard Reichler, *Presumption of Tax Avoidance Motive in Prop. Regs. Affects Many Corporate Bankruptcies*, 74 J. TAX'N 140, 141 (1991).

217 See Prop. Treas. Reg. § 1.382-3(d), 56 Fed. Reg. 47,921 (1991).

218 *Id.* § 1.382-3(d)(2)-(3).

219 *Id.* § 1.382-3(d)(4).

220 For example, one commentator suggests that when substantially all of the assets

Although the regulations provide some examples of the types of claims that constitute indebtedness that arose in the ordinary course of the loss corporation's trade or business, they still leave many unanswered questions. Under the regulations, ordinary course indebtedness includes trade debt, tax liabilities, and certain non-recurring debts, such as liabilities for torts or breach of warranty.<sup>221</sup> The question of whether the term encompasses debts incurred to purchase large capital assets or new lines of business and debts incurred for unusual events, such as a major refinancing, remains unresolved.<sup>222</sup>

Because many corporations have widely held debt that is often actively traded, such debt is not likely to qualify as eighteen-month indebtedness and cannot be ordinary course indebtedness because the same beneficial owners do not hold the debt at all times. Accordingly, the regulations devote themselves almost exclusively to defining a third category of qualified indebtedness, widely held debt.<sup>223</sup> Briefly, the widely held indebtedness rules permit a loss corporation to treat indebtedness held by all less-than-five-percent beneficial owners as always having been owned by the same owners. If the indebtedness was held for the requisite eighteen-month period, it would thus constitute qualified indebtedness.<sup>224</sup> The regulations also provide special rules that the loss corporation can use in attempting to determine the beneficial ownership of its widely held indebtedness. These rules are designed to alleviate the substantial economic burden of such an inquiry.<sup>225</sup> Although the widely held indebtedness regulations are an important contribution to section 382, they are nonetheless fairly complex and will

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of a qualified creditor are purchased, the original creditor and the successor should be treated as a single entity for purposes of the qualified indebtedness rules. See Timothy Sherck, *The Bankruptcy Exception to Section 382: Section 382(l)(5) 6* (Spring 1990) (unpublished manuscript, on file with the *Notre Dame Law Review*).

221 Prop. Treas. Reg. § 1.382-3(d)(2)(B)(iii), 56 Fed. Reg. 47,921, 47,925 (1991).

222 See Sherck, *supra* note 220, at 7. These types of expenditures, unlike tort liabilities, generally would be considered optional and, therefore, may not fall within the ambit of the proposed regulations.

223 See Prop. Treas. Reg. § 1.382-3(d)(3), 56 Fed. Reg. 47,921, 47,925 (1991).

224 A detailed discussion of the widely held indebtedness provisions is beyond the scope of this Article. These provisions, however, have been the subject of several recent articles. See, e.g., Howell Bramson & Sherry W. Bramson, *Prop. Regs. Provide Operating Rules for Bankruptcy Exception to Ownership Change Limits*, 76 J. TAX'N 146 (1992); Robert W. Wood, *IRS Proposes Regulations on NOLs and Bankruptcy*, FAULKNER & GRAY'S BANKR. L. REV., Winter 1992, at 35.

225 See Prop. Treas. Reg. § 1.382-3(d)(3), 56 Fed. Reg. 47,921, 47,925 (1991).

be of no assistance to loss corporations in certain circumstances, such as when the corporation's debt is held in bearer name.

While the proposed regulations defining qualified indebtedness offer bright-line tests for determining those creditors whose claims qualify under the bankruptcy alternative, the regulations severely restrict the debtor corporation's ability to bring in any new creditors because the claims of new creditors likely will not constitute qualified indebtedness. As one commentator observed, "This obstacle to new investors is consistent with the general principles under section 382 against the 'trafficking' in loss corporations. Nevertheless, in the bankruptcy context, where nontax policy favors economic revival of the distressed business enterprise, the confirmation of these restrictions will surely be unwelcome."<sup>226</sup>

Other uncertainties inherent in the bankruptcy alternative warrant brief mention. First, it is unclear whether shareholders and qualified creditors who receive the stock of the loss corporation under the bankruptcy alternative can transfer their stock shortly after they receive it without destroying the fifty-percent continuity requirement. Apparently, the Treasury Department has indicated informally that a subsequent transfer of equity interests will not destroy the fifty-percent ownership requirement, except in a case in which there is a "binding commitment" requiring the transfer of such stock.<sup>227</sup> On the other hand, a private letter ruling issued under section 382 required that creditors of the loss corporation provide a representation that they would not sell or otherwise dispose of their stock received as part of the reorganization plan.<sup>228</sup> Because this issue has not yet been resolved, creditors and shareholders would be well-advised to retain their stock for a period of time following confirmation of the reorganization plan to ensure that they qualify for the bankruptcy alternative.<sup>229</sup>

Another significant uncertainty inherent in the bankruptcy alternative is how it will be applied in a consolidated group scenario. Whether the bankruptcy exception will be applied on a

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226 Rizzi, *supra* note 20, at 138-39 (footnotes omitted).

227 *Id.* at 139 (citing a comment made by the Tax Legislative Counsel on October 11, 1991, at a meeting of the Practicing Law Institute).

228 See Priv. Ltr. Rul. 88-36-058 (June 16, 1988).

229 This issue is similar to the question under § 351 of the Code as to whether transferors are in control of the corporation "immediately after the exchange." See I.R.C. § 351(a) (1988). In the § 351 context, the issue has been resolved in a manner similar to that suggested by the Tax Legislative Counsel in *supra* note 227 and accompanying text.

separate company basis or, instead, on a single entity basis might turn upon which members of the group are involved in the bankruptcy proceedings.<sup>230</sup> Similarly, whether the bankruptcy alternative will apply in a situation involving an informal workout that is not under the jurisdiction of a bankruptcy court remains unsettled. Although the legislative history of the 1986 Act provides that the bankruptcy alternative does not apply to informal workouts, it instructs the Treasury Department to study whether the bankruptcy alternative should apply to such workouts.<sup>231</sup> Some commentators have argued that distinctions between formal bankruptcy proceedings and informal workouts are unfortunate because they encourage loss corporations to seek formal bankruptcy relief, which is more time-consuming and expensive than an informal workout.<sup>232</sup> All of these uncertainties illustrate the difficult decision that a loss corporation faces in attempting to determine whether the bankruptcy alternative will apply in its bankruptcy proceeding and, if so, the effect that the provision will have on its net operating loss carryovers after bankruptcy.

## 2. The Special Insolvency Limitation

Unlike the bankruptcy alternative, no specific regulations have been promulgated addressing issues raised by the special insolvency limitation.<sup>233</sup> Although it is more straightforward than the bankruptcy alternative, several issues remain unresolved that make its application uncertain.

For example, the statute clearly states that, for purposes of the special insolvency limitation, the value of the loss corporation is modified to reflect any increase in the value of its stock attributable to the surrender or cancellation of creditors' claims in exchange for stock.<sup>234</sup> The resulting increase in a loss corporation's stock value, however, is often difficult to calculate. Consider the following scenario: a loss corporation has assets of \$200 million and indebtedness of \$350 million, and thus has an equity value of

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230 See Blanchard, *supra* note 151, at 917 n.9.

231 BLUE BOOK, *supra* note 135, at 322. The Treasury Department was instructed to study such informal workouts and report its findings to Congress before January 1, 1988. *Id.* Formal findings from this study have not yet been announced.

232 See, e.g., Robert A. Jacobs, *Tax Treatment of Corporate Net Operating Losses and Other Tax Attribute Carryovers*, 5 VA. TAX REV. 701, 723 (1986); Rizzi, *supra* note 99, at 132 n.152.

233 *But see infra* note 236.

234 See *supra* notes 193-94 and accompanying text.



a negative \$150 million. As part of a reorganization plan, creditors exchange \$150 million of their debt for half of the loss corporation's stock, and an outside investor infuses \$150 million of new capital into the corporation in exchange for the other half of its stock. The exchange qualifies for the special insolvency limitation because there has been an "exchange of debt for stock in a title 11 or similar case."<sup>235</sup> Immediately after the ownership change, the value of the loss corporation will be a positive \$150 million, because assets have increased to \$350 million and debt has decreased to \$200 million. Is this \$150 million of new value attributable to the cancellation of creditors' claims in exchange for stock, or is it instead attributable to the infusion of new capital by an outside investor? If the former, then the loss corporation can use that value to calculate the annual limitation on the use of its net operating losses to offset taxable income. If, on the other hand, the increase in value reflects the outside investor's infusion of new capital, then the value of the loss corporation still will be zero for purposes of the special insolvency limitation.

This scenario raises a simple issue: which \$150 million, the creditors' or the outside investor's, brings the loss corporation's value from an "under-water" amount of \$150 million to zero? The issue has three possible answers. First, the cancellation of creditors' claims in exchange for stock could drop the corporation's debt to \$200 million, so that with assets of \$200 million the corporation's value is zero. In this case, the entire increase in equity value from zero to a positive \$150 million is attributable to the infusion of new capital. Second, the infusion of new capital could raise the corporation's assets to \$350 million, so that with debt of \$350 million the corporation's value becomes zero. Under this approach, the cancellation of creditors' claims in exchange for stock reduces the corporation's debt to \$200 million, thereby increasing the value of the loss corporation from zero to \$150 million. Of course, this approach offers the greatest benefit under the special insolvency limitation. Third, the cancellation of creditors' claims and the infusion of new capital could operate on a pro rata basis to bring the corporation's value to zero. Under this approach, the increase in value of the loss corporation that is attributable to the cancellation of creditors' claims would be \$75 million, rather than zero under the first approach or \$150 million under the second approach.

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235 I.R.C. § 382(d)(6) (1988).

Unfortunately, there appears to be no guidance as to the resolution of this critical issue.<sup>236</sup> Thus, in cases where a loss corporation has the opportunity to receive an infusion of new capital by an outside investor, it will be very difficult for the corporation's counsel to determine whether the special insolvency limitation or the bankruptcy alternative will provide greater protection for the corporation's net operating loss carryovers. Moreover, as one commentator has noted, even in the absence of an outside investor, it may be difficult to determine the increase in the value of a loss corporation's stock resulting from the cancellation of creditors' claims. The commentator emphasizes that if the loss corporation's stock is publicly traded, the corporation's prior stock value may already reflect the cancellation of creditors' claims.<sup>237</sup> These uncertainties inherent in the special insolvency limitation may render its use inadvisable except in the most clear-cut circumstances.

*C. Lack of Any Policy Justification for the Bankruptcy Provisions'  
Reduction of a Corporation's Net Operating Losses*

Even if the election between the bankruptcy alternative and the special insolvency limitation were not so complex, and the provisions were not fraught with so much uncertainty, an amend-

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236 Just before this Article went to press, the Treasury Department promulgated proposed regulations under § 382(b)(6) that provide guidance on this issue. The regulations generally attribute any increase in the value of the loss corporation's stock as the result of a bankruptcy reorganization to the conversion of creditors' claims into stock, rather than attributing the increase to any infusion of new capital (the stock value test). Prop. Treas. Reg. § 1.382-3(j)(1), 56 Fed. Reg. 34,736, 64,739 (1992). This provision, however, is subject to one important limitation:

[I]f the value of the loss corporation's stock exceeds the value that would have resulted if the loss corporation's creditors had exchanged all of their debt for stock, the excess cannot be from the direct or indirect conversion of debt into stock. In such circumstances, the value of the loss corporation is limited to a value which approximates the value of the loss corporation's stock if the loss corporation's creditors had exchanged all of their debt for stock (the asset value test).

57 Fed. Reg. at 34,737 (official comments to Treas. Reg. § 1.382-3(j)(1)).

Although these regulations represent an important step toward protecting a troubled corporation's net operating losses in bankruptcy, they are only proposed, and not final, regulations. Accordingly, there can be no assurance that they will survive the rulemaking process. Moreover, as discussed *infra* note 252 and accompanying text, even if this issue is ultimately resolved favorably toward debtor corporations, in practice creditors are unlikely to discharge more debt than is necessary to increase the loss corporation's value to zero. Thus, even if the regulations become final, they are not likely to be of great assistance to corporations in Chapter 11 proceedings.

237 Sherck, *supra* note 220, at 28.

ment to the bankruptcy provisions of section 382 would still be necessary because both provisions nearly eliminate a debtor corporation's net operating losses in most circumstances without any policy justification. Congress enacted the bankruptcy alternative and the special insolvency limitation in an effort to facilitate the rehabilitation of financially distressed corporations. In doing so, however, Congress did not provide a broad rule protecting a corporation's net operating losses in all circumstances in which the corporation sought relief under Title 11. Rather, under the bankruptcy alternative Congress afforded net operating loss protection only when the corporation's historic creditors and shareholders retained at least fifty percent of its equity in a Title 11 proceeding.

At first blush, the notion of treating creditors as shareholders of a loss corporation, so as to avoid the general limitation of section 382, seems generous. In reality, however, Congress merely codified a long-standing principle, first enunciated in the landmark Supreme Court case of *Helvering v. Alabama Asphaltic Limestone Co.*,<sup>238</sup> that the creditors of a loss corporation are really its true owners<sup>239</sup> and have borne the losses reflected in its net operating loss carryovers.<sup>240</sup>

Yet at the same time that Congress protected many corporations in bankruptcy from the reach of section 382's general limitation, it exacted a "toll charge" for such protection. Recall that the toll charge requires a corporation to reduce its net operating loss carryovers by (1) paid or accrued interest on debt converted into stock under the reorganization plan for the year in which the ownership change occurs (until the date of the change) and the

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238 315 U.S. 179 (1942).

239 It is interesting to note that although Congress treats creditors as equity holders under § 382(d)(5), the Internal Revenue Service has reached a contrary conclusion in its regulations recently promulgated under § 269. "Although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock." 57 Fed. Reg. 346 (1992) (to be codified at Treas. Reg. § 1.269-5(b)).

240 BLUE BOOK, *supra* note 135, at 299. As one commentator explained,

The approach in TRA '86 of treating creditors in bankruptcy . . . as equity holders is consistent with a number of other provisions in the Code. Thus, for example, for purposes of determining whether postacquisition stock ownership satisfied the statutory continuity of interest requirement, Old § 382(b)(7) treated a creditor who received stock in a bankruptcy reorganization as a stockholder immediately before the reorganization.

Rizzi, *supra* note 99, at 131-32 n.151.

three prior years, and (2) one-half of the amount which would have been treated as debt discharge income in the absence of the stock-for-debt exception.<sup>241</sup> There is little policy justification for the interest disallowance provision and none whatsoever for the debt discharge provision.

The Joint Committee's explanation of the 1986 Act does not offer a policy reason for the interest disallowance provision. The only possible justification for the rule is the following statement contained in the Senate Finance Committee Staff's Final Subchapter C Report: "This rule is based on the notion that the creditor's interest prior to the change was, in reality, an equity interest and, therefore, payments made to the holder of the interest should not be deductible by the corporation."<sup>242</sup> While it is true that payments to equity holders are not deductible, both the legislative history of the 1986 Act and the Supreme Court's holding in *Alabama Asphaltic* acknowledge that it is impossible to determine precisely when creditors' interests shifted from debt to equity interests.<sup>243</sup> Accordingly, the interest reduction provision arbitrarily employs a more-than-three-year interest disallowance rule, implying that creditors' claims were converted into equity three years before the year in which the ownership change occurred. No sound policy considerations justify this implication. Moreover, one leading commentator has suggested that the interest reduction provision "may involve more complexity than it is worth."<sup>244</sup>

Finally, in its present form, the interest provision results in tax planning that undermines other legitimate public policies. For example, because interest "paid or accrued" within the requisite time period results in a net operating loss reduction, commentators have suggested that it would be foolhardy to waste a debtor corporation's assets by actually *paying* interest that had already been *accrued*, since the corporation would suffer a reduction in its net operating loss carryovers of the same amount irrespective of whether the interest was, in fact, paid.<sup>245</sup> Surely Congress did not

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241 For a more detailed explanation of these concepts, see *supra* notes 183-87 and accompanying text.

242 SENATE FIN. COMM. STAFF FINAL REPORT, *supra* note 96, at 250.

243 *Alabama Asphaltic*, 315 U.S. at 183-84; BLUE BOOK, *supra* note 135, at 299.

244 Jacobs, *supra* note 232, at 722. The author does go on to say that the reduction provision is a small price to pay for the bankruptcy alternative, but the article was published before the debt discharge reduction was considered by Congress.

245 Halperin, *supra* note 209, at 153; Sherck, *supra* note 220, at 13.

intend that its tax provisions should discourage a corporation from paying its debts.

Similarly, because a loss corporation's interest deductions are disallowed not only for the three years preceding the ownership change, but also for the year in which the change occurs (until the date of the change), tax practitioners have advised debtor corporations to delay the effective date of their reorganization plans from late in one year until early in the next year. Such planning could reduce the period subject to the interest disallowance provision by up to twelve months.<sup>246</sup> Counseling clients to delay their reorganization efforts may well be prudent tax planning, but it runs contrary to the bankruptcy policy of encouraging prompt rehabilitation of troubled companies. It is easy to see that these factors, taken together, suggest that the interest disallowance provision is not premised on sound policy grounds.

While little policy justification exists for the bankruptcy alternative's interest disallowance provision, there is no justification whatsoever for the debt discharge provisions from a policy standpoint, except as a source of raising revenue. The legislative history of the 1986 Act offers no explanation for the net operating loss reduction, which equals one-half of the corporation's debt discharge income protected by the stock-for-debt exception. The provision was not even part of the Senate Finance Committee Staff's Final Report. Furthermore, when the drafters of the Revenue Act of 1987 attempted to increase the reduction from one-half of the debt discharge amount to one hundred percent of such amount,<sup>247</sup> they again failed to provide justification for this net operating loss reduction.

The stock-for-debt exception to the debt discharge rule is premised on the assumption that the exchange of stock for debt is really just a substitution of one obligation of a corporation for another, and therefore is an inappropriate time to realize gain.<sup>248</sup> This is especially true in the case of a loss corporation, where the creditors are the true owners of the corporation's equity. "[J]udicial recognition of creditor corporate ownership led courts to conclude that a formal conversion of creditor debt into stock did not give rise to [debt discharge income]."<sup>249</sup> Accord-

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246 Sherck, *supra* note 220, at 13.

247 See *supra* note 184 and accompanying text.

248 See *supra* notes 117-20 and accompanying text.

249 Jacobs, *supra* note 189, at 5.

ingly, the bankruptcy alternative's requirement that net operating losses be reduced for such debt discharge income runs contrary to the policies upon which the stock-for-debt exception is premised.

In addition, from a purely practical standpoint, the net operating loss reduction for this debt discharge amount could be quite substantial. Creditors involved in Chapter 11 proceedings often are forced to accept the debtor corporation's stock in exchange for significant portions of their debt. The stock usually has a low value when the corporation emerges from bankruptcy because the corporation must often also retain a large amount of debt. This low stock value, coupled with the cancellation of a significant amount of debt in the exchange, would result in a substantial amount of debt discharge income in the absence of the stock-for-debt exception. Accordingly, a net operating loss reduction equal to one-half of this amount can nearly eliminate a corporation's net operating loss carryovers following bankruptcy.

Finally, the bankruptcy alternative's rule that eliminates a corporation's net operating losses entirely if the corporation undergoes a second ownership change within two years after reorganization is based upon faulty assumptions. First, it assumes that the value of the loss corporation at the time of the first ownership change was zero. While this will often be the case, it cannot be presumed to be true in every instance. Second, the rule assumes that any increase in the value of the loss corporation between the first and second ownership changes will be attributable to shareholders' capital contributions, which would be disregarded in determining the value of the loss corporation for purposes of the second ownership change.<sup>250</sup> Accordingly, the rule assumes that the value of the corporation at the time of the second ownership change will also be deemed to be zero, resulting in an elimination of the corporation's net operating losses. This assumption may be unfair, especially in turnaround cases in which "the price paid for the stock in the second change of control is attributable to the loss corporation's earnings subsequent to the first change in control and its future earnings prospects, rather than to capital contributions 'stuffed' into the corporation during the two-year measuring period."<sup>251</sup>

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250 See *supra* note 188 and accompanying text.

251 Jacobs, *supra* note 232, at 723.

The special insolvency limitation differs from the bankruptcy alternative because it is easier to justify on policy grounds; however, from a practical standpoint, it suffers from the same problems as the bankruptcy alternative because it nearly eliminates the debtor's net operating losses after reorganization. The special insolvency limitation uses the value of the debtor corporation after the ownership change for purposes of calculating the general limitation, thereby reflecting any increase in the value of the stock attributable to debt canceled in exchange for stock.<sup>252</sup> Although no policy was articulated for this rule, presumably it is again based on the notion that creditors of a loss corporation have, in effect, borne those losses, and should be permitted to recoup them in the form of increased loss carryovers.

While this is a laudable goal, in reality creditors often only agree to discharge enough debt to make the corporation solvent (raising the value of the corporation to zero). In such situations, the special insolvency limitation offers no assistance in preserving a debtor corporation's net operating losses. The example employed earlier provides an illustration. In that hypothetical, the loss corporation had \$350 million of debt and \$200 million of net assets. Although it was assumed that the corporation's creditors exchanged all \$350 million of their debt for stock, raising the value of the corporation to \$200 million, the results likely would be quite different in practice. Under most circumstances, creditors would be willing to exchange only \$150 million of their claims for stock and would retain the remaining debt. The creditors would thereby be given preferred treatment up to the value of the corporation's assets, and the corporation would be left with a value of zero for purposes of calculating the general limitation. Thus, as a practical matter, the special insolvency limitation, like the bankruptcy alternative, cannot adequately protect a debtor corporation's net operating losses in Chapter 11.

#### *D. A Proposed Solution*

"Treasury and the IRS have been on a course to restrict the ability of a debtor to fully utilize any beneficial tax provisions related to bankruptcy. It is evident that they perceive these provisions as the 'tax shelter of the 1990s.'"<sup>253</sup> The government's per-

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<sup>252</sup> For a detailed discussion of this concept, see *supra* notes 193-94 and accompanying text.

<sup>253</sup> Eggleston, *supra* note 215, at 21.

ception is erroneous and must be changed. Thus far, Chapter 11 bankruptcies have failed miserably. If the Chapter 11 goal of successfully rehabilitating financially troubled corporations is to be realized, section 382 must be amended so that corporations emerging from bankruptcy can use their pre-bankruptcy net operating losses to shelter their post-reorganization income from tax. The resulting incremental cash flow may well be the factor which allows a troubled company to restructure successfully.<sup>254</sup>

The starting point for the reform proposal should be the bankruptcy alternative. It is premised on the sound assumption that historic creditors of a loss corporation are its true owners and should be treated as equity holders for tax purposes, thereby effectuating the policy of tax neutrality by allowing only the owners of the loss corporation to have unfettered use of its net operating losses. Under the proposal, the general limitation of section 382 will not apply if the historic creditors and shareholders of a debtor corporation in a Title 11 proceeding together receive at least fifty percent of the corporation's stock (in vote and value) pursuant to the reorganization plan.<sup>255</sup> Moreover, the corporation will suffer *no reduction* of its net operating losses as a result of the plan because the current reductions for interest and debt discharge cannot be justified on policy grounds. To prevent an outside investor from taking advantage of the bankruptcy alternative by purchasing creditors' claims just before the reorganization plan is implemented, the definition of a qualified creditor contained in the regulations under section 382(l)(5) should be retained.

Additionally, the rule in section 382(l)(5)(D) (that a second ownership change within two years will reduce net operating losses to zero) should be eliminated because it is based on faulty assumptions. Thus, if an ownership change is triggered after bankruptcy it will only result in the application of the general limitation. To that end, none of the stock received by creditors as part of the reorganization plan would be counted in determining whether there has been a subsequent ownership change. Stock received by an outside investor, however, would count toward a

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254 See Sniderman et al., *supra* note 20, at 199.

255 Of course, this provision mirrors the current bankruptcy alternative. Although one might suggest that creditors merely be treated as shareholders for purposes of applying § 382's general limitation, such a proposal will not prove effective because it is impossible to identify their percentage holdings before the ownership change (even though the creditors are recognized as equity holders for tax purposes).



second ownership change. Thus, if, as part of a reorganization plan, creditors receive forty percent of a loss corporation's stock, an outside investor receives forty-five percent of the stock, and shareholders retain the remaining fifteen percent, the forty-five percent interest received by the outside investor would count toward an ownership change after bankruptcy. This rule would prevent an outside investor from purchasing a corporation solely for its net operating loss carryovers. Without such a rule an investor could, for example, purchase a fifty-percent interest as part of the reorganization plan that would not count toward an ownership change. The investor could then obtain control of the loss corporation shortly thereafter by purchasing stock received by a creditor under the plan without triggering an ownership change. The goal of the bankruptcy provisions is to allow creditors, not outside investors, to obtain control of the loss corporation without imposing limitations on the use of the corporation's net operating losses thereafter. Any other rule would encourage investors to purchase troubled companies solely for tax purposes, a result that contravenes the principle of neutrality embodied in section 382.

One of the most effective ways that a debtor corporation can use the bankruptcy process to reorganize successfully is to dismantle and sell off unprofitable lines of its business. The corollary to the continuity-of-business-enterprise requirement, found in the new regulations under section 269<sup>256</sup> and applicable to loss corporations employing the bankruptcy alternative, contravenes this bankruptcy tool and runs contrary to sound business judgment by requiring a corporation to continue unprofitable businesses solely for tax purposes. Accordingly, the section 269 regulations should be repealed insofar as they relate to bankruptcy proceedings.<sup>257</sup>

Finally, the special insolvency limitation should be abolished. It is of little value for most debtor corporations because in most instances the cancellation of creditors' claims in bankruptcy merely raises the corporation's value from a negative number to zero. Moreover, whatever benefit the provision may have is outweighed by the undue complexity and significant attorneys' fees that are associated with requiring corporations to choose between the two alternatives.

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256 See *supra* notes 209-13 and accompanying text.

257 Although it is beyond the scope of this Article, the author believes that the Senate Finance Committee Staff's Final Report was correct in asserting that § 269 should not even apply to transactions governed by § 382.

Some critics might argue that if Congress amends section 382(l)(5) to enable debtor corporations to preserve their net operating losses following bankruptcy and shelter their post-reorganization income from tax, the government will lose the revenue that could be generated by taxing that income. Although it is difficult to determine the possible adverse revenue impact that this proposal would occasion, the preservation of jobs and increased competition that would result from implementing this proposal should counterbalance any lost revenue by decreasing welfare costs and allowing a once-troubled corporation to prosper.

The proposal outlined above will undoubtedly have the effect of preserving a debtor corporation's net operating loss carryovers in a bankruptcy proceeding under most circumstances. It should also improve the ability of many corporations to reorganize successfully in Chapter 11. Whether the amendment alone can dramatically change the success rate of Chapter 11 bankruptcies remains to be seen.

## V. CONCLUSION

All experts agree that the Chapter 11 reorganization provisions are not working well in practice. There are two possible solutions to this problem. First, as some prominent commentators have suggested, the Chapter 11 provisions can be eliminated, so that troubled corporations seeking protection under the Bankruptcy Code are forced into liquidation. In the alternative, if one believes that the fundamental goals of the Chapter 11 provisions are sound, then it would be preferable to devise approaches that will improve the Chapter 11 system. The author is of the view that the Tax Code provisions affecting corporations in Chapter 11 proceedings should be modified in order to achieve the Chapter 11 goals of preserving jobs, promoting competition, stimulating the economy, and reorganizing troubled businesses.

This Article does not attempt to discern all of the reasons why the goals of the Chapter 11 provisions have not been achieved. Rather, it merely suggests that one reason why Chapter 11 has proven unsuccessful is the failure of the Tax Code provisions to preserve a troubled corporation's net operating losses following bankruptcy. The Article offers a solution which is designed to preserve this valuable asset. Implementation of this solution will bring Chapter 11 one step closer to achieving its goals.

